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The Separation of Commercial and Investment Banking: The Morgans vs. the Rockefellers — **Alexander Tabarrok**

Against Fiduciary Media — **Hans-Hermann Hoppe with Jörg Guido Hülsmann and Walter Block**

The Intertemporal Adam Smith — **Roger W. Garrison**

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EDITORIAL

The Quarterly Journal of Austrian Economics is nominally a brand new journal. But, in terms of its mission and guiding spirit, it is a continuation, in an expanded and improved form, of the first ten volumes of the semi-annual *Review of Austrian Economics*, whose founding editor was the late Murray N. Rothbard. The *QJAE* features the same Editors who succeeded Rothbard in the editorship of the *RAE* beginning with volume 8, number 2. Our mission now, as it was when we adopted it from Rothbard, is "to promote the development and extension of Austrian economics and to promote the analysis of contemporary issues in the mainstream of economics from an Austrian perspective." With a quarterly journal, which will be vigorously promoted by a publisher of wide academic renown, Transaction Periodicals Consortium of Rutgers University, we are confident that we will be even more successful in fulfilling this mission than before.

The editorial policy of the *QJAE* is shaped by our Kuhnian perspective on the development of science, including and especially economic science. Thus, we do not believe the future of the Austrian school lies in courting the acceptance of the mainstream economics profession by demonstrating that the realism or coherence of mainstream theories may be marginally improved by the incorporation of a handful of watered-down and shopworn subjectivist or market-process caveats. That way lies co-optation or irrelevance. While we do not share his epistemological relativism, Thomas Kuhn has reminded us that scientific progress occurs not by a process of smooth and ever-broadening consensus among different approaches, but via jarring and revolutionary paradigm shifts.

If our ultimate goal is not to become a cautionary footnote to mainstream economics, what is it then? It is to completely displace the crisis-ridden but entrenched positivism by a vital and full-blown praxeological paradigm. To this end, the *QJAE* offers a forum for those interested in further elaborating and refining the system of praxeological economics, or in pioneering its application to new areas of interest. This forum is open, as well, to articles expressing cogent criticisms of Austrian economics that are useful in provoking a rethinking and clarification of crucial points of its theory, policy, or method.

As was the case during our tenure with the *RAE*, we will not shy away from controversy, regardless of whose oxen are gored. In this vein, we welcome articles employing Austrian economic theory to evaluate and demolish faddish and foolish developments in mainstream economics, which have proliferated so rapidly of late—a sure sign of a paradigm in the latter stages of crisis and self-liquidation. As a means of appealing to a broader readership, we also encourage the submission of articles that subject an important contribution, or even the entire oeuvre, of a Nobel Laureate in economics or of a rising young star of the profession to the rigorous scrutiny of praxeological economic theory.

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Recognizing that a healthy diversity of viewpoints exists within Austrian economics, the *QJAE* will continue the policy, followed in previous volumes of the *RAE*, of inviting and airing different views on issues of key importance. We believe that the controversies aired in the last few volumes of the *RAE*—about the nature and consequences of free banking, the interpretation of the socialist calculation debate, and whether problems of calculation or knowledge or both are at the core of Austrian economics—manifest the tremendous vitality of the praxeological paradigm. Therefore, we intend to continue to invite contributions that elucidate and help to resolve these issues, while cultivating reasoned debate on any new issues that may pique the research interests of Austrian scholars.

Like the production of economic goods and services, the discovery of new economic truth cannot be centrally planned; rather it depends on the free interaction of individual minds. If the *QJAE* comes to serve as a useful arena for that interaction, we will have fulfilled the mission we assumed as editors.

Walter Block
Hans-Hermann Hoppe
Joseph T. Salerno

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THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING: THE MORGANS VS. THE ROCKEFELLERS

ALEXANDER TABARROK

The Banking Act of 1933, sometimes referred to as the Glass–Steagall Act, separated commercial and investment banking, instituted Federal deposit insurance, prohibited interest payments on demand deposits, and reorganized the Federal Reserve. The Glass–Steagall Act is typically explained as a public-interest measure designed to rectify persistent problems in the banking system, and to combat the immediate banking crisis. I will argue, however, that important portions of the Act can be better explained through a public-choice analysis that emphasizes a struggle between rival elements in the banking industry.

The focus of this discussion will be on the separation of commercial and investment banking and on other aspects of the Glass–Steagall Act, as well as Carter Glass.[1] Public-interest rhetoric was used to justify the separation of commercial and investment banking. Recent work by White (1986), Benston (1990), Kroszner and Rajan (1991) and others have shown that this rhetoric cannot be supported in theory or in fact. Banks that combined deposit and investment banking were safer than deposit banks without affiliates, and they issued higher quality securities than did independent investment banks. I argue that the separation of commercial and investment banking can be better understood as an attempt by the Rockefeller banking group to raise the costs of their rivals, the House of Morgan.[2] Both the House of Morgan and the Rockefellers, during the 1930s, wielded enormous political and economic power; so as to better understand the Morgan and Rockefeller rivalry, some background is in order.

PUBLIC-INTEREST ARGUMENTS

Proponents of the Glass–Steagall Act argued that separating commercial and investment banking would increase the safety and reduce bank and customer conflicts of

ALEXANDER TABARROK is associate professor of economics at Ball State University. I wish to thank Tyler Cowan and Hugh Heclo for comments; and Murray N. Rothbard for comments on an earlier version of this paper. Any remaining errors are solely my own.

[1] On deposit insurance, see Golembe (1960), Preston (1933), and Friedman and Schwartz (1963).

[2] On the theory of "raising rivals' costs," see Salop and Scheffman (1984) and Williamson (1968).

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interest. Neither of these arguments bares close scrutiny here. At the most basic level, it is clear that many securities (stocks and bonds) are less risky than are loans. Security investments are also liquid and publicly observable. Liquidity lets banks quickly rebalance their portfolios to avoid runs, and public observability improves the efficiency of bank monitoring by depositors and bond holders. Even if all securities were riskier than all loans, forbidding banks to invest in securities could increase bank risk because of the benefits of diversification (see Macey 1991).

The Supreme Court, economists, historians, and others have uncritically referred readers to the Pecora–Glass Subcommittee Hearings and to other hearings for evidence that banks with security affiliates created an undue risk to depositors. But in an exhaustive reading of all the relevant material, Benston (1990) has found no evidence to support this conclusion. The hearings are replete with unsupported assertions and bald hypotheses, but no evidence on the risk of unified banking was ever presented. Since then, evidence has been found which strongly indicates that separated banking is riskier than unified banking. White (1986) has examined the failure rate in 1930–33 of national banks without security affiliates and national banks with security affiliates. He finds that banks without security affiliates were four times as likely to fail as were those with affiliates.

Another argument against unified banking is that a bank with security affiliates has a conflict of interest. Senator Bulkley, a strong supporter of the Glass–Steagall Act, put the argument as follows:

> Obviously, the banker who has nothing to sell his depositors is much better qualified to advise disinterestedly and to regard diligently the safety of depositors than the banker who uses the list of depositors in his savings department to distribute circulars concerning the advantage of this, that, or the other investment on which the bank is to receive an originating profit or an underwriting profit or a trading profit.[3]

This argument might apply to a fly-by-night outfit, but once long-run profits and reputation are included in the analysis, the conclusion is reversed. The more an investment advisor has to lose by offering bad advice, the less likely this is to occur. Poor investment advice on the part of a securities affiliate is likely to lead investors to leave that affiliate and to withdraw their funds from the parent bank. Investors, therefore, are able to threaten stronger punitive action if they invest with a unified bank than if they invest with an investment bank alone.[4]

The conflict of interest argument is also contradicted by investor behavior. Unified banks (banks with affiliates or security operations) were rapidly increasing their share of the bond issuing market in the 1920s. In 1927, for example, commercial banks and their affiliates were responsible for 36.8 percent of all issues, and in 1930 for 61.2 percent of all issues (Peach 1941, p. 110). If the conflict of interest argument were true, one would expect rational investors to abandon unified banks rather than flock to them. More consistent with this evidence is the finding of Kroszner and Rajan

[3]Quoted in Macey (1984, p. 15).

[4]Benston (1990), Saunders (1985), and Kelly (1985) deal with the conflict-of-interest arguments in greater depth.

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(1994) that unified banks issued higher quality securities (*ex post*) than did investment banks acting alone.[5]

The public-interest explanation is at wide variance with the facts. To explain the Glass–Steagall Act, therefore, requires either that Congress acted in great error or that the motivation behind the Act was not the public interest.[6,7]

THE ROCKEFELLERS AND THE HOUSE OF MORGAN[8]

Aside from the Federal government, the House of Morgan and the Rockefeller family were the largest and most important economic and political entities in U.S. history. Like the pre-war Japanese *zaibatsu*, the House of Morgan and the Rockefellers controlled large sections of the U.S. economy. In an age of unlimited campaign funds, these groups could also easily make or break a politician's career. In 1933, the Pecora investigation revealed that J.P. Morgan's "preferred list," people who were given stock at far below market prices, included more than one ex-president, a host of treasury secretaries from both political parties, the chairman of the Republican National Committee, the chairman of the Democratic National Committee, and many other politicians and men of affairs (Chernow 1990, p. 370). From their base in Ohio, the Rockefellers also dabbled in politics. Mark Hanna, the legendary Republican operative and Ohio Senator, was a schoolmate of John D. Rockefeller, as well as a lifelong friend and business ally (Lundberg 1937, p. 58). It was through Hanna that the Rockefellers influenced the McKinley administrations. McKinley's election in 1896, for example, was supported by a $250,000 donation from Standard Oil, a gift which was repeated in the election of 1900. Hundreds of thousands more in campaign funds were organized through Rockefeller's other firms and business interests (ibid, pp. 60–61).

Rockefeller also influenced politics through Nelson Aldrich. Aldrich was Rhode Island's Senator for thirty years, during which time his net worth increased from $50,000 to at least $12 million (Lundberg 1937, p. 61).[9] As chairman of the Senate finance committee and Republican whip, Aldrich controlled the nation's largesse. In his 1905 series in *McClures* titled "Enemies of the Republic," Lincoln Steffens

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[5]Benston (1990) also finds that the evidence for this assertion in the documentary record is weak to non-existent. Many of the supposed abuses of the banking industry turn out to be fabrications or misreading of the actual evidence in the record.

[6]Even though the documentary record does not indicate either excessive risk or abuses, it was in the interest of Pecora and the investigating committee to suggest that it did. As a direct result of his investigation, and the publicity he generated, Pecora became a commissioner of the newly created Securities and Exchange Commission. (On the exaggerations of Pecora and others and their interests, see Carosso [1985, 1973] and Karmel [1980, p. 631].) The media uncritically adopted Pecora's story, and over time it became accepted as fact. Until Benston (1990), few researchers bothered to investigate the actual data and testimony upon which Pecora's view supposedly rested. For a model of this type of herd behavior, see Benerjee (1992) and Scharfstein and Stein (1990).

[7]I suspect, more precisely, that the majority of Congress supported the Glass–Steagall Act because of mistaken impressions as to its effects, while a minority supported the Act and guided it through Congress because of their special interests.

[8]The political and economic power of J.P. Morgan and Company and the Rockefellers is well documented in Chernow (1990), Kolko (1963), Burch (1980; 1981), Lundberg (1937), and Collier and Horowitz (1976).

[9]Collier and Horowitz (1976, p. 93) estimate Aldrich's fortune at closer to $30 million.

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called Aldrich the "boss of the United States," and David Graham Phillips's series in *Cosmopolitan*, "The Treason of the Senate," devoted an entire chapter to Aldrich titled "Aldrich, the Head of it All." Aldrich's connection with the Rockefellers began financially and politically, but became familial when his daughter Abby married John D. Rockefeller, Jr. (Abby's brother Winthrop is also a key player in the separation of commercial and investment banking; see below). Through Aldrich, the Rockefellers (and other New York bankers) had a profound influence on the creation of the Federal Reserve. Aldrich chaired the National Monetary Commission of 1910 that produced the "Aldrich Plan" which, with slight modifications due to Carter Glass and his advisor H. Parker Willis, became the foundation of the Federal Reserve System (Friedman and Schwartz 1963, p. 171). Little known at the time, Aldrich's plan was hammered out by Aldrich, Morgan, Rockefeller, and Kuhn, Loeb partners at a secret 1910 meeting held on Jekyll Island, Georgia (Chernow 1990, p. 127; Rothbard 1984; Kolko 1963, chap. 8).

The Rockefellers' wealth and power flowed from Standard Oil, but later expanded into banks and other industries. The House of Morgan's power came not from the wealth of J.P. Morgan per se, but from Morgan's strategic position in the U.S. economy. At the turn of the century, American industry underwent a series of mergers and restructurings that reshaped the economy. J.P. Morgan and his bank stood at the center of this great change. In 1901, Morgan engineered the greatest merger of all time, creating U.S. Steel with an initial capitalization of $1.4 billion at a time when GNP was approximately $20 billion. An equivalent merger today would be capitalized at around $350 billion. Morgan's commissions alone were worth about $15 billion in 1993 dollars. Morgan's influence was felt in all of the major industries of the day, especially railroads, utilities, and steel.

The 1912 Pujo hearings into the so-called "money trust" (a code word for the Morgan empire), revealed that J.P. Morgan and his partners were principal shareholders of dozens of the largest U.S. corporations and that, in total, they held 72 directorships in 112 corporations (Chernow 1990, p. 12). DeLong (1991; 1992, p. 17) estimates that Morgan-centered groups were in some way connected with 40 percent of all the industrial, financial, and commercial capital in the United States. Twenty-one years later, the Pecora hearings revealed a similar story; Morgan partners held 126 directorships in 89 corporations with a total of $20 billion in assets, representing approximately one-third of GNP (Chernow 1990, p. 366).

Political power flowed from the House of Morgan's economic power. In 1896, William Jennings Bryan ended his speech to the Democratic convention with the famous oath "you shall not crucify mankind upon a cross of gold." Bryan was talking primarily about J.P. Morgan who, with Grover Cleveland, had saved the gold standard a year earlier.[10] Throughout this period, Morgan partners and associates were important advisors and financial backers to presidents and the political elite. In the 1904 election, for example, the Morgan bank gave $150,000 to Theodore Roosevelt's campaign fund, in return for which George Perkins, a Morgan partner, became chief

[10]Bryan's speech is reprinted in Hofstadter and Ver Steeg (1969). Chernow (1990, chap. 5) deals with Morgan's rescue of the gold standard.

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advisor to Roosevelt throughout his political career (Chernow 1990, p. 112). It was Perkins who pressed Roosevelt to run in 1912 and who supplied Roosevelt with over $500,000 in campaign funds (Hofstadter 1974, p. 304).[11]

At the 1912 Democratic Convention, Bryan again attacked the House of Morgan, thundering that no representative of J.P. Morgan should ever receive the Democratic Party's Presidential nomination. In 1924, however, at the height of Morgan's power, he had to accede to the nomination of John W. Davis, chief lawyer of the House of Morgan.

Morgan and Rockefeller power did not go unopposed. William Jennings Bryan, as already noted, was implacably opposed to the Morgans and the Rockefellers, and, as Secretary of State under Woodrow Wilson, fought against their control of the Federal Reserve. Allied with him were progressive intellectuals like Louis Brandeis, Felix Frankfurter, and Lincoln Steffens. Brandeis, in particular, attacked J.P. Morgan and Company, throughout his career as a lawyer, advisor to Wilson, and associate Justice of the Supreme Court.[12] Politicians like Huey Long, Robert LaFollette and others found strong support for attacking the Morgans and the Rockefellers among the public, who feared the monster trusts. Perhaps more importantly, politicians played the rival coalitions against one another. The Morgans supported attacks on the Rockefellers, and the Rockefellers supported attacks on the Morgans.[13] Indeed, a combination of public outrage and political maneuvering by the Rockfellers was responsible for the separation of commercial and investment banking.

The Morgans and the Rockfellers clashed often. The chief economic rival of the House of Morgan was a formidable combination of Rockefellers (oil, banking), Harrimans (railroads), and bankers primarily associated with Kuhn, Loeb and Lehman Brothers.[14] In the twentieth century, John D. Rockefeller, Jr., W. Averell Harriman, son of E.H. Harriman, and the second generation of bankers at Kuhn,

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[11]Perkins left the Morgan firm in 1912.

[12]Chernow (1990, p. 176) called Brandeis "the most cunning and resourceful foe the House of Morgan would ever face." During the Pujo hearings, Brandeis wrote a series of influential articles for *Harper's Weekly* under the title of "Other People's Money; and How the Bankers Use It." These articles were a direct attack on J.P. Morgan and Company and the "money trust." "Other People's Money," was reprinted during the Pecora hearings of 1933 in book form (Brandeis 1933).

[13]Morgan–Rockefeller rivalry as well as the ultimate power of the Federal government meant that the Morgans and the Rockefellers were by no means always the controlling powers. The fact that money flowed from Wall Street to Washington alone cannot tell us in which direction power flowed. The dominant public-choice theories of regulation emphasized the demand for regulation by organized special-interest groups (Peltzman 1976; Becker 1985). Politicians, however, are active players in the regulatory and redistributive process, and not mere passive suppliers reacting to private interest-group demand. The relationship between J.P. Morgan and Company and Theodore Roosevelt, for example, was at times ambivalent and even hostile. It was Roosevelt who launched the first trust-busting attack on the Morgan empire with the Northern Securities Case of 1902. Payments to Roosevelt and other politicians should therefore be seen as partly a response to threats of regulation and control. See McChesney (1991) for a model of this type of behavior.

[14]Although Morgan and Kuhn, Loeb and sometimes Lehman Brothers would often cooperate on issues, there was always an underlying economic rivalry to which was added J.P. Morgan's anti-Semitism. See Chernow (1990, p. 90 and passim).

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Loeb, and Lehman Brothers were the main instigators of the attack on the House of Morgan, of which the 1933 separation of commercial and investment banking was the most important aspect of the struggle. The attack was led and organized by Winthrop Aldrich of Chase National Bank.

GENESIS OF THE BANKING ACT

John D. Rockefeller, Sr., had moved into banking by investing the cash reserves of Standard Oil in the National City Bank. James Stillman was the president of National City, and two of Stillman's sons married daughters of William Rockefeller (brother to John D. Rockefeller, Sr.), making this a family alliance (Lundberg 1937, p. 10). The cash reserves of Standard Oil were so great that this single source made National City one of the largest banks in New York. The Rockefellers, especially John D. Rockefeller, Jr., wanted to dominate banking as they did oil, and around 1911, Rockefeller, Sr., made substantial investments in Equitable Trust. Using Equitable as a base, the Rockefellers rapidly expanded their bank holdings through a series of mergers (see Johnson 1968, pp. 80–110). By 1920, Equitable, which had started out as a small bank, was the eighth largest bank in the country, and it continued to grow through merger and expansion throughout the 1920s.

In 1929, Winthrop Aldrich became president of Equitable Trust. Winthrop Aldrich was John D. Rockefeller, Jr.'s brother-in-law, and was the son of the famous Senator Nelson Aldrich (a key player in the formation of the Federal Reserve).[15] A lawyer by training, he was reluctant to enter banking, but did so at the urging of John D. Rockefeller, Jr., who had guided his career from its inception (see Johnson 1968, p. 93; and Collier and Horowitz 1976, p. 159). Under Aldrich, Equitable merged with the Morgan-dominated Chase National Bank. Chase's director was then Albert H. Wiggin. Wiggin had been a protégé of George F. Baker and Henry P. Davison of First National Bank, both of whom were prominent within the Morgan group (Johnson 1968, p. 101). Aldrich then become president of the newly formed Chase Bank, and Wiggin became chairman of its Governing Board.

The position of president at Chase was initially not a powerful one. From 1920 to 1929, of the five men who had been president of Chase only Wiggin lasted more than two years. The lack of continuity meant that power rested with Wiggin. Aldrich, however, moved quickly to establish his own power by promoting his own men and cutting the number of bank directors. An unpleasant corporate battle ensued in which Aldrich was opposed by Wiggin, Thomas Lamont, and other executives allied with the House of Morgan.[16] By 1931, Aldrich held the dominant position, and Wiggin went into retirement with a suspiciously large pension.[17]

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[15]The Aldrich and Rockefeller families were very close. Two of Rockefeller's sons were named Nelson R. and Winthrop, Aldrich family names. Nelson Rockefeller worked at Chase during this period (Johnson 1968, p. 187).

[16]On Lamont's attempts to block Aldrich, see Ferguson (1984, p. 81).

[17]Wiggin retired with an astounding pension of $100,000 a year. This became the subject of embarrassment during the Pecora hearings as neither Wiggin nor Aldrich could adequately explain why Wiggin's pension was so large. Aldrich and Wiggin were barely on speaking terms by 1932 and, according to Aldrich, the differences between them were such that both of them could not

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As Roosevelt took office in 1933 the great depression was at its trough, 15 million workers were unemployed, real gross national product had fallen by nearly 30 percent since its peak in 1929, and gross investment was virtually nil (Temin 1976). The public looked back at the financial boom of the twenties and deemed this the original sin. Bankers and financiers, feared and admired in the twenties, were feared and reviled in the thirties. Politicians fueled the public's animosity. In his inauguration speech, Roosevelt attacked the "money changers" as "callous," "unscrupulous," and "selfish," at the same time as he called for unprecedented power for himself and "a trained and loyal army willing to sacrifice for the good of a common discipline."[18] In Congress, the Pecora hearings and later the Nye hearings fueled the same fire. The Nye hearings of 1936 accused Morgan of being a "merchant of death" responsible for America's entry into World War I, and the Pecora hearings purported to show a banking history of "profits, greed, expansion, power, and domination."[19]

Without the great depression and the outrage that was generated by the Pecora hearings, the separation of commercial and investment banking would probably not have occurred.[20] As it was, the Pecora hearings revealed that Jack Morgan had paid no income tax since 1930, and that none of the twenty Morgan partners had paid income tax in 1931 or 1932 (Chernow 1990, p. 366). Other members of the Morgan group, most particularly Albert Wiggin, were also accused of income tax evasion. Although all of the "evasion" was legal and due mostly to huge stock losses, the public was infuriated. Seligman (1982, p. 29) reports that bankers "became the object of near-hysterical rage." The public demanded that some action be taken, but it was left to the insiders, like Winthrop Aldrich, to determine the direction of change.

Aldrich and the Rockefeller banking group were initially ill served by the Pecora hearings. Wiggin still represented Chase National in the minds of many, and his disgrace reflected on the bank. The other Rockefeller bank, National City, was also being investigated, and its Chairman, Charles Mitchell, and its President, Hugh Baker, were forced to resign in late February of 1933. Aldrich had to find some way to protect the Rockefeller banks.

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remain at the bank (see U.S. Congress, Senate 1934.4018). The solution was evidently to pay off Wiggin so he would exit gracefully. Wiggin's pension was what we today would call a "golden parachute" paid to Wiggin so that he would leave Chase rather than continue to fight the Aldrich–Rockefeller takeover. On the information in this note, see Johnson (1968, pp. 107–38); my interpretation differs significantly from his. On golden parachutes as an incentive device to lower the costs of takeovers, see Knoeber (1986).

[18] Roosevelt's speech can be found in Peterson (1954).

[19] The list is from a rhetorical question by Senator Bulkley: "Did not professional pride become diverted from the pride of safe and honest banking service to that of profits, greed, expansion, power, and domination?" Quoted in Benston (1990, p. 124).

The public-choice school of political science and economics has emphasized the special interest nature of most regulation, but has left unexamined the techniques of power which politicians use to mobilize political support from a diffuse and rationally ignorant public. A study of the link between hearings and regulation could be very valuable.

[20] See on this point Willis and Chapman (1934, p. 101), Seligman (1982, pp. 2, 29), and Kennedy (1973, p. 212).

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On March 7, National City Bank's new Chairman James Perkin announced that the bank would divorce its security affiliate. On March 8, Aldrich followed Perkin's surprise announcement with a sweeping plan for bank reform that many in the banking community called a "betrayal."[21] Aldrich denounced the connection of investment banking and commercial banking as "almost inevitably leading to abuses." He threw his support behind the Glass bill to separate commercial banks and their security affiliates, but he argued that the bill did not go far enough. In addition to the current provisions, Aldrich argued that (1) private banks should be regulated as heavily as commercial banks; (2) private banks should be forced to separate their commercial and investment divisions; and (3) no interlocking directorates between any type of bank and securities firm should be allowed.[22]

The purpose of Aldrich's strategy is obvious to contemporary observers. The *New York Times* made Aldrich's announcement front page news on March 9 with the headline "Aldrich Hits at Private Bankers in Sweeping Plan for Reforms." The *Times* noted that Aldrich, "who is a representative of the John D. Rockefeller interests," was attacking "some of Wall Street's most powerful figures and their particular interests." More than anyone else, the Aldrich program "strikes directly at the position of J.P. Morgan and Company." "W. W. Aldrich, First Challenger to House of Morgan" was a profile of Aldrich published several days later in the *World Telegram*.[23] The *Wall Street Journal* was more circumspect, but also alluded darkly to a Rockefeller conspiracy to vanquish J.P. Morgan and Company.

Most devastating to the House of Morgan was Aldrich's third point, the ban on interlocking directorates. More than any other aspect of the Glass–Steagall Act, it was the ban on interlocking directorates that separated commercial from investment banking; of the twenty Morgan partners, ten were directors of at least one commercial bank (*New York Times*, March 9, 1933). Moreover, the officers of Morgan-controlled banks, such as George F. Baker of the First National Bank, were also often directors of other banks. The extent of the connection between banks in the Morgan group was probably best illustrated by the finding of the Pecora committee that J.P. Morgan and Company had given "loans" to sixty officers and directors of other banks. As Jack Morgan noted "They are friends of ours, and we know that they are good, sound, straight fellows."[24]

The interlocking directorates of the Morgan group, which extended to many corporations as well as to other banks, meant that Morgan could economize on transaction and information costs as well as overcome problems of adverse selection and moral hazard. The Morgan bank was not large, but because of its ties to commercial

[21] Aldrich's announcement was widely publicized the following day, March 9. Surely not coincidentally, this coincided with the convening of the new Congress.

[22] See Aldrich's statement in the *New York Times* (March 9, 1933, pp. 1, 2). Aldrich also wanted to limit the number of directors a bank could have (point four in this statement). A new statute limiting directors would save Aldrich the trouble of an unpleasant fight to terminate or eliminate through attrition excess Chase directors; Aldrich's own bank, Chase National, was top heavy with directors because it had grown through mergers.

[23] *New York World Telegram* (March 13, 1933), quoted in Johnson (1968, p. 152).

[24] Quoted in Chernow (1990, p. 364).

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banks, J.P. Morgan and Company could finance huge security issues with very low reserve requirements. If U.S. Steel, for example, wanted to issue new securities, they would be bought by J.P. Morgan and Company, which financed the purchase through a loan from a large—and related—commercial bank like First National. U.S. Steel would not need the entire proceeds immediately and would simply deposit the funds from Morgan into another Morgan bank, perhaps even First National. (And when the money was spent it might go to a firm like General Electric, which also banked with Morgan). J.P. Morgan and Company would then market the securities and deposit the proceeds. Other investment houses could not finance large security issues because they lacked extensive connections with the large commercial banks who alone could advance the enormous sums needed in the intermediate process. If information were free, any investment bank could borrow money on a good issue. But in a world of high transaction costs and moral hazard, investment banks without close ties to commercial banks were credit rationed. The essence of Glass–Steagall was not the ban on deposit banks issuing securities but the ban on interlocking directorates. Aldrich alone pushed this through Congress.

The separation of commercial and investment banking was costly to Chase National and the other Rockefeller banks as well as to Morgan. Indeed, Wiggin and chairman of the Chase board, Charles McCain, had been among the most vociferous critics of separation.[25] Aldrich's actions, therefore, cannot be understood simply as an attempt to increase profits through government entry restrictions.[26] Instead, Aldrich's actions must be understood as an attempt to raise his rivals' costs. The theory of "raising-rivals' costs" shows that it is possible for a firm to increase its profits by raising industry costs so long as the costs to its rivals increase more than its own costs (and demand is not too elastic). Consider a regulation that raises industry costs but, because of heterogeneity among firms, raises the costs of firm B more than the costs of firm A. There are two effects: the industry as a whole will shrink when costs and prices rise, and firm A will lose some proportion of these customers. Firm A, however, will gain some of the customers who leave firm B because firm A's prices do not rise as much as do those of firm B. Loosely speaking, if the second effect outweighs the first, firm A can benefit from the regulation.[27] A

[25]During Wiggin's testimony to the Pecora investigation, Aldrich stood close by and repeatedly indicated that Chase was no longer following the policies of the Wiggin regime. McCain, too, was disgraced by Aldrich's renunciation of his policies, and resigned as chairman of the board in 1934. Aldrich replaced him shortly thereafter, thus cementing the Rockefeller takeover.

[26]Shughart (1988), Macey (1984), and Benston (1982) speculate that the Glass–Steagall Act was passed in order to benefit commercial and/or investment bankers with entry restrictions. Although this is a possible motive for supporting the Act, none of these authors demonstrate that the special interests they discuss had (and used) the political power necessary to push the act through Congress. The micro-history approach of this article is able to pinpoint which groups had and used the requisite political power.

[27]More technically, to increase profits the initiating firm's residual demand curve must rise more than its average costs. The size of the residual demand increase depends upon the increase in rival-firm costs and the elasticity of total demand. The more inelastic total demand is the more an increase in rival-firm costs leads to an increase in the initiating firm's residual demand. See Salop and Scheffman (1983). Raising the costs of one's rival can also work in a perfectly competitive industry if firms earn rents, and costs hit disproportionately so as to reduce the elasticity of the

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classic case of this type of behavior is a capital-intensive firm with labor-intensive rivals supporting unionization (Williamson 1968).

The raising-rivals' cost theory fits the evidence of the House of Morgan and the Rockefeller banking group. The House of Morgan's strength was built on interlocking directorates and unified banking to a much greater extent than were the banks of the Rockefeller group. Chase's security affiliate was not making money during the depression, and it was about to be investigated by the Pecora committee. This explains why Aldrich lobbied for the separation of commercial and investment banking, even though it meant that Chase would be split along with J.P. Morgan and Company. The Rockefeller group had less to lose from separation than did the Morgans, and they had more to gain from supporting the administration. Significantly, after Aldrich came out for separation, the administration's investigation of Chase was quickly dropped.

Carter Glass, the nominal author of the separation legislation, never wanted to regulate the private bankers. Prior to Aldrich's lobbying, drafts of the Glass Bill specified only that national banks would be separated. Glass's reluctance to regulate the private bankers may have been in part because of constitutional qualms, but Glass was also close to the House of Morgan. Glass was a good friend of Morgan partner Russell Leffingwell. Leffingwell, on leave from Morgan, had been one of Glass's chief assistants when Glass was Secretary of the Treasury under Wilson. Leffingwell and Glass became quite close during this time, and after Leffingwell returned to Morgan they communicated often. Leffingwell used his contacts to organize donations to Glass's political campaigns, and Glass took note of Leffingwell's comments on banking policy.[28] When Roosevelt asked Glass to be Secretary of the Treasury, Glass indicated he wanted Leffingwell and another Morgan man, Parker Gilbert, as under secretaries. Roosevelt, however, refused any connection with the House of Morgan and vetoed Glass's choices. Roosevelt's veto was one of the reasons Glass ultimately rejected the Treasury position.[29] When Aldrich's proposals were drafted into the Glass–Steagall Bill, Glass wrote to Leffingwell that he had been against the provision attacking Morgan but that Roosevelt had foisted it upon him.[30]

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supply curve, thereby increasing price and infra-marginal rents. Coate and Kleit (1994) and Boudreaux (1990) provide useful introductions to the raising rivals cost literature as well as a critique of the idea that a firm can raise its rivals' costs without government involvement.

[28]On the proceeding two sentences, see the Leffingwell–Glass correspondence, Box 283 in the Carter Glass Papers at the University of Virginia. Leffingwell wrote to Glass at one point saying he felt their relationship was closer to that of son and father than that of boss to subordinate; see letter to Glass of April 23, 1929. Leffingwell and Glass disagreed strongly about the Glass–Steagall bill, and their correspondence became somewhat testy during the 1932 period. See, for example, letters of April 22, 25, 26, 1932, and February 9, 1932. On Leffingwell's campaign funding, see Glass's letter of November 19, 1929.

[29]See *Business Week* (March 15, 1933, pp. 4–5) and Chernow (1990, pp. 355, 374–75).

[30]This is reported in Chernow (1990, p. 375), who cites a letter from Glass to Leffingwell. The Leffingwell personal papers are located at Yale University. See also Glass's comments in the U.S. Senate (1934, p. 4032), where he indicates that he thought the provision "extremely severe" and went along with its inclusion only after Aldrich's request and after being pressured by the administration (p. 4016).

Glass's connections with the House of Morgan should not be over emphasized. Glass had an

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Aldrich followed up his surprise announcement with intense lobbying. Throughout March he traveled between New York and Washington, D.C., frequently meeting with Roosevelt, Carter Glass, Secretary of Commerce Daniel Roper, and other high officials in the Roosevelt administration (Johnson 1968, p. 156; Ferguson 1984, p. 82).[31] Secretary of Commerce Roper was particularly helpful. Roper sent Glass and the banking committee a letter expressing the administration's support for Aldrich's position. Roper's intervention into an area in which Glass believed his committee had exclusive jurisdiction annoyed Glass, but the administration was able to signal its views nonetheless.[32] Aldrich was also aided by Colonel House, the famous advisor to Woodrow Wilson and then Franklin D. Roosevelt. House's daughter was married to Gordon Auchincloss, Aldrich's best friend and a member of the Chase board, and Aldrich used this connection to lobby House (Ferguson 1984, p. 82). House, in turn, contacted Roper and later Roosevelt, urging them to meet with Aldrich.[33] Vincent Astor, Roosevelt's cousin and good friend, was also on the board of Chase, and he too served as a conduit to bring the two groups together (Ferguson 1989, p. 15; Burch 1980, p. 21). Aldrich's lobbying paid off when Glass—reluctantly—allowed him to draft the key sections of the Glass–Steagall Act that separated commercial and investment banking. These sections were section 21, which forbade deposit taking institutions from issuing or underwriting securities, and section 32, which forbade interlocking directorates.[34]

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independent power base in Virginia and did not need the New York bankers to any great extent. Moreover, Glass was a devotee of the real-bills doctrine, especially as espounded by his long-time aide Professor H. Parker Willis. According to Willis, all commercial bank credit should be based upon short-term self-liquidating loans—all bank purchases of securities were therefore suspect in his view. Glass, therefore, had ideological or public-interest reasons to support the separation of commercial and investment banking, although it seems clear that he was reluctant to apply separation to private bankers.

[31]Ferguson (1984) is a critical paper for understanding of the political–business nexus of the New Deal.

[32]See Glass's comments in the U.S. Senate (1934, p. 4016).

[33]Writing to Secretary of Commerce Roper, Colonel House noted,

> Winthrop Aldrich . . . got in touch with me yesterday through Gordon Auchincloss. I found Aldrich sympathetic to the last degree of what the President is trying to do, and I advised him to tell the Banking Committee the whole story. He is prepared to do this, and has gone to the country today to write his proposed testimony in the form of a memorandum, a copy of which he is to send to me tomorrow morning. He intimated that if there was any part of it that I thought should be changed he would consider doing so. (quoted in Ferguson 1984, p. 83)

Ferguson implies Aldrich's contact with House helped to bring the Glass–Steagall Act to "fruition." This must be qualified. House's letter was written in October of 1933, several months after the Glass–Steagall Act had been signed into law (June 13, 1933). The letter concerns Aldrich's testimony in November of 1933, which was in favor of strengthening the Glass–Steagall Act. There was a movement to repeal Glass–Steagall before separation went into effect, so in this sense Aldrich's lobbying after June 13 was in support of Glass–Steagall. Furthermore, Aldrich was also influential in the Banking Act of 1935, which continued the anti-Morgan elements of the Banking Act of 1933. House's letter is therefore an important indication of Aldrich's lobbying efforts.

Roosevelt's letter to House of December 20, 1933, in Roosevelt (1947) illustrates that House contacted Roosevelt and encouraged him to see Aldrich.

[34]The fact that Aldrich wrote these sections came out in Aldrich's testimony in the Pecora hearings in December of 1993 (see U.S. Senate, 1934, p. 4032).

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Aldrich also moved to turn the attention of the Pecora investigation away from Chase and toward Morgan. The *New York Times*, for example, concluded its March 9, 1933, article on Aldrich's reform plan with the following insight into his motivation.

> Although the plans of the Senate investigating committee have not formally been disclosed, it has been reported that the affairs of the Chase National Bank's security affiliate and the affiliates of the other important banks were to have been gone into shortly with a thoroughness equal to that displayed in the National City Company investigation.

Several weeks later the results of Aldrich's maneuvering were evident. In a lively article titled "Next, Morgan and Company," *Business Week* noted that "Commercial bankers with investment affiliates get a chance to breathe and mop their brows as the Senate's stock market investigators turn from them to . . . the lordly private banking House of J.P. Morgan and Company." For their reprieve, commercial bankers must doff their hats to

> Winthrop Williams Aldrich, head of Rockefeller's world-largest Chase National Bank, who is credited with having maneuvered so cunningly that Morgan and Company now occupy an uncomfortable eminence between him and the government's guns.[35]

W. Averell Harriman's Bank, Brown Brothers, Harriman, was also notably absent from Pecora's investigation (Schlesinger 1958, p. 441). Harriman was a long-time friend of Franklin and Eleanor Roosevelt, and he used his connections to become a powerful and important figure in the Roosevelt administrations (Burch 1989, p. 55). Over the four administrations, he held a variety of diplomatic and administrative posts, including chairmanship of the Department of Commerce's Business Advisory Council, an administrative post at the National Recovery Administration (first at the New York Division and then nationally), and Secretary of Commerce (Kouwenhoven 1968, p. 202).[36]

The Business Advisory Council (BAC) was essentially a lobby group for big-business, but was made more powerful by its official designation as part of the Department of Commerce. The BAC was established in June of 1933, probably to provide a forum for discussions between the new administration and the nation's top economic interests (Burch 1980, p. 18). Although initially open to small businesses, and to both the Morgans and the Rockefellers, it quickly came to be dominated by the

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There is some confusion over exactly what Aldrich wrote. In the hearings, Glass maintained that Aldrich wrote section 32, and Aldrich initially agreed but suggested that the final form was somewhat different than what he wrote originally. A few minutes later, however, Aldrich denied that he wrote section 32 but claimed that he had assisted in writing section 21.

Section 32 actually contains two clauses, the ban on interlocking directorates and then a weaker version of section 21. It is the second clause over which Aldrich and Glass dispute. Once this is understood, the Glass–Aldrich exchange makes sense. Aldrich, in my judgment, wrote the first clause of section 32 as Glass says (recall that the ban was first proposed by Aldrich at his newspaper conference), but the second unrelated clause I believe was added later (as Aldrich argues). Glass does not dispute that Aldrich aided in the draft of section 21.

[35] *Business Week* (April 12, 1933), pp. 12, 14.

[36] Harriman's brother Roland was also an influential supporter of the New Deal, as were other partners of Brown Brothers, Harriman, like Prescott Bush and Robert Lovell (see Kouwenhoven, 1968, p. 203).

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Rockefeller group. Harriman, who was associated with the Rockefellers in a number of business enterprises, served first as the BAC's vice-chairman, then as chairman. Aldrich was also a member of the BAC and, appropriately enough, was made chairman of the BAC's committee on banking legislation in November of 1934 (Johnson 1968, p. 198). Other prominent members associated with the Rockefellers included Gerald Swope, President of General Electric and a director of National City Bank, and Walter C. Teagle, president of Standard Oil, in which the Rockefellers still maintained a large stake (Burch 1980, p. 19).

Harriman's bank, Brown Brothers, Harriman, was created in 1931 when the recently formed Harriman Brothers and Company merged with Brown Brothers and Company. Brown Brothers had originally been involved in both deposit banking and investment banking, but they had taken huge losses in the 1929 crash and, under Harriman's guidance, they began to focus on commercial banking. By 1933, the new bank was doing the great majority of its business in commercial banking. Brown Brothers, Harriman, therefore, would also gain from an attack on the House of Morgan. Harriman's interests were allied with those of the Rockefellers and, with Harriman's close ties to Roosevelt, he and his partners were clearly in an excellent position to influence banking legislation.[37]

Section 8 of the Banking Act took the control of open-market operations away from the New York Fed and placed it with the Federal Reserve Board. The House of Morgan had dominated Federal Reserve policy throughout the 1920s through Benjamin Strong, the legendary governor of the Federal Reserve Bank of New York.[38] Section 8 was the response from several groups that had not benefited under Strong's regime.

Strong was closely associated with the House of Morgan throughout his career. As Chernow (1990, p. 182) puts it, Strong "had Morgan written all over his resume." This was literally true. In 1904 Harry Davison, later a Morgan partner, hired Strong as secretary of the Bankers Trust Company (succeeding another Morgan partner, Thomas Lamont). Bankers Trust, which stood opposite J.P. Morgan and Company at Broad and Wall Street, had been created by Morgan as a funnel for trust business that the Morgan bank could not legally handle. During the Panic of 1907, Strong became

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[37]Harriman was also closely connected with the banking houses of Kuhn, Loeb and Lehman Brothers; see Burch (1980, pp. 21–24).

It is interesting to note that when Brown Brothers, Harriman, was split, its investment bankers formed a new investment bank with former bankers of National City.

[38]The legend of Benjamin Strong is told by monetarists and economists of the Chicago school, who claim that had Strong lived, the Great Depression could have been avoided. Irving Fisher, who originated the Strong legend, stated that "Governor Strong died in 1928. I thoroughly believe that if he had lived and his policies had been continued, we might have had the stock market crash in a milder form, but after the crash there would not have been the great industrial depression." Quoted in Friedman and Schwartz (1963, p. 413, see also pp. 411–19) who defend the Strong legend at length.

The essence of the Strong legend is that Strong used open-market operations to avert liquidity crises in 1924 and in 1927 and would have done so again in 1929–30. Research by Wheelock (1991), Wicker (1966), and Rothbard (1980, 1984) shows, however, that Strong's open-market operations were aimed at supporting Britain, and not at controlling the domestic economy.

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one of Morgan's trusted lieutenants and his personal auditor. By 1914, he was president of Banker's Trust, and was in that year asked to become the Governor of the newly created New York Federal Reserve Bank.

Strong initially decided to turn down the position of Governor; but, over a long weekend in the country, Harry Davison and Paul Warburg convinced him to accept. Strong was particularly close to Morgan partner Harry Davison. Strong's life was beset by several tragedies; his first wife committed suicide in 1905, and a daughter died a year later. During this period, he felt unable to look after his remaining three children properly, and his friend, Davison, took them into his home.[39]

Strong's close connections to the House of Morgan are not brought forward as evidence that Strong was controlled by the House of Morgan—this would be a facile interpretation and, given Strong's legendary willpower, an unlikely one. Strong, however, came from the same milieu as the Morgans: he lived in the same neighborhoods and joined the same country clubs. As we have seen, his career was guided by Morgan partners, and his best friends were Morgan partners. Strong's biographer, Lester Chandler (1958, p. 25), notes: "three men who were to have a great influence on his thinking and his future were Henry P. Davison [Harry], Thomas W. Lamont, and Dwight W. Morrow." Each of these men worked for J. P. Morgan and eventually became partners of the House of Morgan.

The House of Morgan was solidly internationalist, as was Benjamin Strong. The New York branch of the House of Morgan, J.P. Morgan and Company, was matched by Morgan Grenfell and Company in London, and of Morgan et Compagnie in Paris. Edward Grenfell (later Lord St. Just) was senior partner of Morgan Grenfell and Company, a director of the Bank of England, and Morgan's main contact with the British political class. At the beginning of World War I, Davison went to Britain and, with Grenfell's help, had J.P. Morgan and Company appointed Britain's purchasing agent in America.[40] France also made Morgan their financier and purchasing agent. In return for a one percent commission (and the implicit opportunity to direct purchases to Morgan firms like U.S. Steel), Morgan used their monopsony power to buy over $3 billion worth of supplies for the British alone, about half of Britain's total purchases.

To finance their purchases, Britain and France needed massive loans, and, over the course of the war, Morgan arranged $1.5 billion in Allied credits. To help with the financing of the loans, Morgan enlisted Strong. Strong, who was virtually in complete control of the Fed, lent huge sums to the commercial banks, created a market in acceptances to finance trade, and timed gold inflows and open-market purchases to ease the money market as the Allied loans were floated. After the war, Strong and the House of Morgan worked closely to maintain international trade, and in particular, to bring Britain back on to the gold standard. For his part, Strong engaged in open-market purchases to keep U.S. interest rates below British rates, so gold would

[39]On these points, see the biography of Strong by Chandler (1958, pp. 20, 31, 39, and passim) and Chernow (1990, p. 123, 182).

[40]The theory behind this was to make Morgan give monopsony powers so they could keep prices low.

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not flow out of Britain. Strong also continued to keep credit conditions easy in the United States so that reconstruction loans for Europe could be floated in the U.S. (e.g., Chandler 1958, pp. 271–71 and note 42). The House of Morgan cooperated by keeping open a $100 million line of credit to the British Treasury to defend against speculative attacks.[41]

Strong's actions aroused the ire of at least three groups: Chicago Bankers, Californian A.P. Giannini, and Carter Glass. The isolationist and pro-German mid-West attacked Morgan's financing of Britain as warmongering. In Chicago, pro-German depositors threatened to boycott any banks that participated in the British loans (Chernow 1990, p. 200). Furthermore, in the late 1920s, Chicago banks were heavily invested in short-term government securities; Strong's open-market operations to lower interest rates, thus cut directly into their earnings (see Epstein and Ferguson 1984, and Chandler 1958, pp. 439–53, on the ire of the Chicago bankers).[42] By 1928, Chicago banks were in open opposition to Strong's control, and Chicago papers were calling for Strong's resignation (Time, July 30, 1928).

California banker A.P. Giannini (of Transamerica) also felt locked out of the New York clique. Giannini strongly supported the New Deal banking reforms and, as a result, became the unofficial ambassador of California big business to Washington. Giannini was responsible for several small clauses of the Glass–Steagall Act, especially section 5114, which required that minority stockholders of a national bank be given the right to elect representatives to the board in proportion to their stock holdings. Giannini had recently gained a tenth interest in National City Bank but was frozen out of power due, he believed, to Morgan opposition. Giannini felt that he would be better served by a Washington-controlled Federal Reserve Board than by a Morgan-controlled New York Fed and, accordingly, in discussions with Roosevelt and the administration, especially Marriner Eccles, he lobbied for the shift of power to the Board.[43]

Carter Glass was also against Strong's control of open-market operations. Glass, along with many others, believed that Strong had too much power and that his expansionist policies were the cause of the stock market boom as well as the excessive speculation of the 1920s (see Chandler 1958, pp. 163–64, 449–50). Although he had not always approved of the Board's actions, he chose the board over the unregulated control of the New York Fed (Chandler 1958, p. 449).

With these three forces against them, and with the death of the charismatic Benjamin Strong in 1928, the Morgans had little chance of retaining control of the Fed; section 8 was the logical result.

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[41] On the events in this paragraph, see Tansill (1938, pp. 32–134, esp. 86–88), Rothbard (1980, 1984), Chernow (1990, chap. 10 and pp. 274–77), Anderson (1979, pp. 38, 47), Chandler (1958, chap. 6, esp. pp. 117–24, and chap. 8, esp. pp. 316–19), and Wheelock (1992).

[42] Since the Chicago banks were holding short-term securities, any capital gains on their portfolio were small and fleeting.

[43] Giannini also benefited from the extension of branch banking.

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CONCLUSION

The public-interest arguments for the separation of commercial and investment banking are weak and appear unable to explain the passage of the Banking Act. The separation of commercial and investment banking is better explained by private-interest politics. Shughart (1988), Macey (1984), and Benston (1982) argue that private interests, like investment bankers, benefited from the Banking Act, and they speculate that these interests supported the Act, but they provide no direct evidence.

The micro-history approach of this article has pinpointed the specific individuals who were responsible for the Glass–Steagall Act's provisions separating commercial and investment banking. More than anyone else, Winthrop Aldrich, representative of the Rockefeller banking interests, was responsible for the separation of commercial and investment banking. With the help of other well-connected anti-Morgan bankers like W. Averell Harriman, Aldrich drove the separation of commercial and investment banking through Congress. Although separation raised the costs of banking to the Rockefeller group, separation hurt the House of Morgan disproportionately and gave the Rockefeller group a decisive advantage in their battle with the Morgans.

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AGAINST FIDUCIARY MEDIA

HANS-HERMANN HOPPE
WITH JÖRG GUIDO HÜLSMANN AND WALTER BLOCK

Almost all contemporary Austrian economists are united in their opposition to central banking and their advocacy of a system of free competitive banking. However, a vigorous debate has arisen over the precise meaning of "free competitive banking." Does "free banking" require 100 percent reserve deposit banking, or does it allow or even require fractional reserve banking? In a recent article that appeared in the *Review of Austrian Economics,* George A. Selgin and Lawrence White (1996), the two most prominent contemporary Austrian proponents of "free banking" as fractional reserve banking, have undertaken a systematic attempt to answer their numerous Austrian critics and defenders of 100 percent reserve deposit banking.[1]

Against the charges made by their critics, Selgin and White try to establish two theses. First, they claim to show that the practice of fractional reserve banking, that is, the issue of fiduciary media, does not constitute fraud but is justified by the principle of freedom of contract, and in particular they contend that fractional reserve banking is in accordance with the title-transfer theory of contract as developed by Murray N. Rothbard (such that Rothbard, who holds that fractional reserve banking *is* fraudulent, must have failed to grasp his own theory). Second, they attempt to show that the creation of fiduciary media does not of necessity lead to economic inefficiencies and discoordination but may actually help prevent an otherwise unavoidable

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[1]Selgin and White (1996, pp. 83–107). All page numbers in the text reference this article.

Curiously, in the reply to their various critics, Selgin and White selected as their central target an article by Hoppe (1994) that deals only cursorily with their position. Other Austrian critics of fractional reserve banking explicitly dealt with in Selgin and White's article including Block (1988) and de Soto (1995). Murray N. Rothbard, the most prominent critic of fractional reserve banking, is targeted only indirectly; and although several of his works are mentioned in their bibliography, Rothbard's later writings on the subject (1988; 1992; 1995) are not mentioned. Likewise ignored entirely are the criticisms by Salerno (1991a; 1991b; 1993). Selgin and White also do not address, and in this case could not have done so, the most recent and most extensive criticism of their work by Hülsmann (1996).

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crisis and thus improve economic performance. In the following, we will demonstrate that neither the central normative claim nor the secondary positive claim is established.[2]

THE ISSUE OF FRAUD I: MONEY, MONEY SUBSTITUTES, FIDUCIARY MEDIA, AND THE TITLE-TRANSFER THEORY OF CONTRACT

In order to resolve the question of whether or not fractional reserve banking constitutes fraud, from the outset a few factual assumptions and terminological issues will have to be clarified. Fortunately, almost complete agreement on these matters exists on both sides of the debate, and thus we can be extremely brief. Money cannot but originate as a commodity, such as gold. Gold, then, as money, is defined as "the generally acceptable medium of exchange," and as such is uniquely characterized by its "supreme salability in comparison with all other assets" (such that its "possession puts one in the position of being able to make any potential purchase with minimum inconvenience") (White 1989, p. 247). Money substitutes, in turn, are defined as claims or titles to specified amounts of money (gold). If money substitutes (paper notes) are fully covered by reserves of money (gold), Mises denotes them "money certificates," and we will refer to them here simply as money substitutes. If money substitutes (paper notes) are uncovered by money (gold), they will be referred to as fiduciary media instead.[3]

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[2]As a doctrinal matter, Selgin and White also suggest that their view of fractional reserve banking coincides with Ludwig von Mises's view; hence, they call themselves Misesians (and claim it is the defenders of 100 percent reserve banking who are deviationists). This claim can be rejected. In fact, Selgin (1998, pp. 60–63) has frankly acknowledged that Mises's and his own views concerning fiduciary media are contradictory, and White's attempt to claim Mises as a proponent of fractional reserve free banking has been addressed by Salerno (1993). Here it suffices to provide a quotation from Mises (1978, pp. 438, 448):

> The main thing is that the government should no longer be in a position to increase the quantity of money in circulation and the amount of checkbook money not fully—that is, 100 percent—covered by deposits paid in by the public. . . . No bank must be permitted to expand the total amount of its deposits subject to check or the balance of such deposits of any individual customer . . . otherwise than by receiving cash deposits . . . or by receiving a check payable by another domestic bank subject to the same limitations. This means a rigid 100 percent reserve for all future deposits; that is, all deposits not already in existence on the first day of the reform.

See also notes 7, 14, 22, 27, 28 below.

[3]See Salerno (1994, p. 76). Selgin and White highlight the fact that Hoppe referred to them as proponents of "partial fiat money," but then are ultimately compelled to admit that he did in fact not misrepresent their position as advocates of fractional reserve banking based on an underlying gold standard. Their complaint amounts to no more than a dispute over semantics. We will treat it as such here, too, and will concentrate instead exclusively on substantive disagreements.

There is actually more to the charge of Selgin and White being fiat money advocates in the article under scrutiny. For, in "the mature free-banking system," according to Selgin and White (but in contrast to the analysis of the operation of such a system given by Mises), a situation is supposed to emerge in which

> at the limit, if inter-clearinghouse settlements were made entirely with other assets (perhaps claims on a super-clearinghouse which itself holds negligible commodity money),

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Based on these assumptions and definitions, we can now turn to the question of whether or not the issue of fiduciary media constitutes fraud. Fortunately, the discussion of this issue is facilitated by the fact that Selgin and White explicitly accept the Rothbardian title-transfer theory of contract. That the issue of fiduciary media is inherently fraudulent, as Rothbard and Hoppe claim, Selgin and White find

> impossible to reconcile with Rothbard's . . . title-transfer theory of contract, which we accept, and which Rothbard otherwise uses to defend the freedom of mutually consenting individuals to engage in capitalist acts with their (justly owned) property. Rothbard . . . defines fraud as "failure to fulfill a voluntarily-agreed-upon transfer of property." Fractional-reserve arrangements cannot then be *inherently* or *inescapably* fraudulent. Whether a particular bank is committing fraud by holding fractional reserves must depend on the terms of the title-transfer agreement between the bank and its customers. (pp. 86–87)

> Whether it is fraudulent to hold fractional reserves against a bank liability does not depend *per se* on whether it is a demand or time liability, but only on whether the bank has misrepresented itself as holding 100 percent reserves. The demandability of a particular claim issued by a bank, that is, the holder's contractual option to redeem it at any time, is not per se a representation that the bank is holding 100 percent reserves against the total of its demandable claims. Rothbard . . . argues otherwise, based on the view that a bank's demand deposits are necessarily "warehouse receipts" and not debts. We do not see why bank and customer cannot contractually agree to make them debts and not warehouse receipts, and we believe that historically they have so agreed. (p. 87, n. 8)

While this may sound plausible at first glance, it does not withstand serious scrutiny. In fact, the quoted passage reveals that the most basic lesson concerning property and contract has been overlooked. As Hoppe (1994, p. 67) formulated it, "two individuals cannot be the exclusive owner of one and the same thing at the same time."[4] This is an immutable principle; it is a law of action and nature that no contract can change or invalidate. Rather, any contractual agreement that involves presenting two different individuals as simultaneous owners of the same thing (or alternatively, the same thing as simultaneously owned by more than one person) is

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> and if the public were completely weaned from holding commodity money, the active demand for the old-fashioned money commodity would be wholly nonmonetary. (White 1989, p. 235)

Thus, notes Salerno (1994, p. 76, n. 7) regarding Selgin and White's ultimate objective, "the public would presumably finally be freed from its shackles of gold to enjoy the virtues of an invisible-hand-generated private fiat money." Moreover, as far as semantic innovations and deviations from orthodox Misesian terminology, and hence potential sources of confusion are concerned, we have to consider Selgin and White's own writings. For in referring to money and money substitutes as "outside" and "inside" money respectively, in talking of "base money," "basic money," "bank money," "high-powered" and "low-powered" money, and, yes, the gold dollar "as a substitute for bank deposits," they display an unusual degree of semantic creativity. Moreover, in suggesting, by their selection of terms, that all of these things are somehow equally "money," their writings actually have become a source of obfuscation. See on this Hülsmann (1996, p. 5ff).

[4] It is also "impossible that some time depositor and borrower are entitled to exclusive control over the same resources" (Hoppe 1994, p. 67).

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objectively false and thus fraudulent.[5] Yet this, precisely, is what a fractional-reserve agreement between bank and customer involves.

In issuing and accepting a fiduciary note (at a necessarily discounted price), both bank and customer have *in fact*, regardless of whatever they may believe or think about the transaction, agreed to represent themselves—fraudulently—as the owner of one and the same object at the same time. They have in fact contracted to create additional titles and claims to the same existing quantity of property. In issuing fiduciary notes, they do not—and cannot—bring more property into existence. Indeed, no contract whatsoever can possibly increase the existing quantity of property, but can only transfer (redistribute) existing property from one person to another. The quantity of existing property can only be increased through additional appropriation and production (and a thus enlarged quantity of property can in turn lead to a correspondingly increased number of titles to property). But fractional reserve banking and the issue of fiduciary media, while it does not and cannot increase the amount of property in existence, also does not involve (as all other contracts *do*) a transfer of existing property or titles to existing property from one hand to another. Neither does the issue and acceptance of a fiduciary note signify a transfer of property from bank to client or *vice versa*. To be sure, as the result of a fiduciary issue, the distribution of assets and liabilities in the accounts of bank and client is altered. But no existing quantity of property is actually transferred from bank to client, or vice versa, and the total quantity of property in existence has remained unchanged. Rather, fiduciary media represent new and additional titles to or claims on an existing and unchanged stock of property. They are not the result and documented outcome of an additional supply of property on the part of the bank or its client. Instead, they represent an additional supply of property *titles*, while the supply of *property* has remained constant. It is precisely in this sense that it can be said of fiduciary media that they are created out of thin air. They are property-less titles in search of property. This, in and of itself, constitutes fraud, whether according to Rothbard's definition of the term as "a failure to fulfill a voluntarily-agreed-upon transfer of property" or according to Selgin and White's own definition of it as "a *willful* or *deliberate* deception for purposes of gain." Each issuer and buyer of a fiduciary note (a title to money uncovered by money), regardless of what he may believe, is in fact—objectively—engaged in a misrepresentation for the purpose of personal gain. The bank and its client have consented to misrepresent themselves as the owners of a quantity of property that they do not own and that plainly does not exist; and whenever they buy an existing quantity of property in exchange for titles to a non-existing quantity of property, they have become invariably and inescapably guilty of an act of fraudulent appropriation.[6]

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[5]Even partners cannot simultaneously own the *same* thing. A and B can each own half of a household, or half the shares in it, but they each own a *different* 50 percent. It is as logically impossible for them to own the same half as for two people to occupy the same space. Yes, A and B can both be in New York City at the same time, but only in different parts of it.

[6]De Soto (1995, p. 33) correctly likens the effect of fractional reserve banking to that of the so-called tragedy of the commons. Selgin and White (pp. 92–93, n. 12) object to de Soto's analogy on the ground that the tragedy of the commons refers "to a particular sort of technological externality,"

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Selgin and White's failure to recognize this, and their belief in the ethical innocence of fractional reserve banking, is due to two confusions. On the one hand, as has already been indicated, they do not recognize that no object—and no quantity of money (gold)—can be owned by more than one party at a time and that no contract can possibly increase the quantity of property in existence, and thus that any pretension to the contrary is inherently fraudulent. On the other hand, and intimately related, Selgin and White do not recognize the fundamental praxeological difference between property and property titles. Rather, in subsuming money (gold) and money substitutes (banknotes) under the same heading of "money," they continually obfuscate this very distinction. For if money (gold) and titles to money (banknotes) are both defined as "money," then it indeed seems to follow that it does not make any difference whether the supply of money or that of banknotes increases. Both are "money" and hence, by definition, in both cases the same event—an increase in the supply of money—has taken place. But this does not alter the facts; it only defines them out of existence.

Of course, as Selgin and White correctly note, everyone is free to adopt any definition and make any distinction that he wishes. Yet definitions do not create real distinctions; they can, though, make them disappear. They can only either reflect such distinctions or else ignore and confuse them; and clearly, to refer to both money and money substitutes indiscriminately as money is to obscure the difference between two categorically—praxeologically—distinct phenomena and states of affairs. A title to money and an increase of titles is not the same thing as money and an increase of money. Rather, unlike an increase in the quantity of money (gold) or an increase of titles backed by a corresponding increase of money, any increase in the quantity of titles to money unaccompanied by an increased quantity of money necessarily implies that one and the same quantity of money is owned by more than one person at the same time; and since such a thing is physically impossible —the quantity of money is unchanged and all existing money must be presently owned by someone—every redemption of a fiduciary title, then, be it into money or any other form of real property, involves an act of illicit appropriation.

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according to Selgin and White, involves "a physical or otherwise direct interference with someone's consumption or production" and represents "interaction outside the market." In contrast, write Selgin and White, the "externality from fiduciary media" is a harmless pecuniary "effect on someone's wealth transmitted via the price system," that is, through changes in the system of relative prices, and represents "an interdependence through the market." Selgin and White err: an object and a title to an object are not the same thing.

In lumping money and money substitutes together under the joint title of "money," as if they were somehow the same thing, Selgin and White fail to grasp that the issue of fiduciary media —an increase of property titles—is not the same thing as a larger supply of property and that relative price changes effected through the issue of fiduciary media are an entirely different "externality" matter than price changes effected through an increase in the supply of property. With this the fundamental distinction between property and a property title in mind, de Soto's analogy between fractional reserve banking and the tragedy of the commons makes perfect sense. As under the scenario of a tragedy of the commons, every issue of fiduciary media—to titles in search of property—sets in motion a rush, always starting with the bank and its client, to fill these empty tickets with existing property; and in the course of this rush, invariably the firstcomers will physically enrich themselves (through the appropriation of existing quantities of property) at the expense of a corresponding impoverishment of latercomers, whose quantity of existing property is physically diminished while they have been left with a larger number of property tickets.

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Assume there exists both property itself and property titles (notes). Besides property in consumer goods, producer goods, and money, titles to consumer goods, titles to producer goods, and titles to money are assumed to exist. The origin of property titles in addition to the existence of property itself promotes legal certainty and reduces and facilitates legal disputes, and hence undoubtedly represents a beneficial (natural) development. Moreover, it allows for two innovations. On the one hand, it becomes possible to separate the act of transferring ownership in property from the act of transferring its possession. That is, it becomes possible to surrender or acquire ownership in objects without simultaneously surrendering or acquiring possession, disposition, and control of the very same objects. Applied to money it becomes possible that, all the while the ownership of existing quantities of money (gold) can change constantly from one person to another, the entire quantity of money may remain—unchangingly—in the hands of one and the same bank (as the manager of money owned by others). On the other hand, with the development of property titles, intertemporal exchanges will be systematically facilitated. Existing (present) property or titles thereto may be transferred in exchange against titles to future property (debt claims); and hence it will be also assumed that next to titles to existing property (consumer goods, producer goods, and money), titles (debt claims) to future consumer goods, future producer goods, and future money exist and are traded as well.

In light of these developments, the following transactions (contracts) between any two parties A (bank client) and B (bank) are possible. A may transfer his money (gold) into B's disposition and thereby either (1) *not* give up his ownership in it, or (2) *give* up his ownership. There is no third *possibility*. If (1), then A keeps the title to the sum of money transferred to B; B does not have title to it, but acts as a money warehouser (a bailee) for A (as a money bailor). *There is no third possiblity*. If (2), then B acquires the title to the quantity of money put into its disposition by A; A receives from B in exchange either (a) a present—existing—quantity of consumer and/or producer goods previously possessed and owned by B; or (b) a title to a present—existing—quantity of consumer and/or producer goods in B's possession (but owned now by A) (an equity claim); or (c) a title to a quantity of *future* consumer and/or producer goods and/or money (a debt claim). *Again, there is no third possibility*. That is, A cannot both retain ownership of this property *and* transfer it to B.

Among all possible transactions, not one would result in the issue of a fiduciary note. Fiduciary media, according to Selgin and White's own definition, are "that portion of redeemable money substitutes backed by assets other than base money" (p. 85). There are money (gold) and money substitutes (titles to money) in existence, and there are titles to non-money goods (equity titles), and titles to not-yet-existing future goods (debt claims). Apparently, however, no such thing as "money substitutes backed by assets other than base money" would arise out of any of these transactions. Selgin and White *assume* the existence of fiduciary media (and they simply *assume* that the absence of fiduciary media must be the result of legal restrictions), but they do not provide a praxeological explanation and reconstruction of the origin of such a peculiar entity and state of affairs. Rather, they only ask, why not? "We do not see why bank and customer cannot contractually agree to make them [that is, demand deposits and banknotes] debts and not warehouse

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receipts." *Why* is it that there can—and should—be no money substitutes backed by assets other than money? For the same reason that there can and should be no car or house titles backed by assets other than cars or houses, that there can and should be no equity titles backed by assets other than equity, and that there can and should be no assets—money, equity, or debt—owned (backed) by more than one person at a time. Titles to money are—and should be—backed by money in the same way and for the same reason as titles to cars are and should be backed by cars. This is what defines them as property titles. It is in accordance with and a reflection of the nature of property and property titles. In distinct contrast, a title to money backed by assets other than money is a contradiction in terms, and its issue and use involves the same sort of objective misrepresentation as the issue of a title to a car backed by assets other than a car (parts of planes and bikes, for instance).[7]

The answer to why fractional reserve agreements are ethically impermissible, and why there can be no contracts to make warehouse receipts debt, is that such agreements and contracts contradict (deny) the nature of things. Any such contract is from the outset—a priori—invalid. Selgin and White try to get around this inescapable conclusion by adopting, wittingly or not, an ultra-subjectivist view of contracts and agreements. According to this view, the very fact that a voluntary agreement is

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[7]Similar logic-semantic confusions are at work when Selgin and White try to reduce the difference between demand and time liabilities to one of degree rather than kind (p. 90). Explains Selgin (1988, p. 62): "Holders of demand liabilities are granters of credit just as are holders of time liabilities. The only difference is that in the former case the duration of individual loans is unspecified; they are 'call loans' that may mature at any time"; and "Mises," who holds the opposite view, "confuses a difference of degree with one of substance." In fact, it is Selgin who is confused.

To be sure, one might say that it is only a matter of degree whether a loan (of a car or of money) matures in an hour, a day, a week, or a month. Just as surely, however, this does not change the categorical distinction between present—existing—goods and not (yet) existing future goods. At any point in time, a car or a sum of money (gold) either exists or it does not exist. Nor does it alter the praxeological datum that no one, at any time, can act with anything except present goods. Future goods are the goal of actions, but in order to attain them, every actor must first invariably employ present means (goods). Nor does Selgin's observation concerning degrees of time affect in the slightest the fundamental human condition of scarcity. The supply of present goods is at all times limited, and the limited quantity of present goods limits in turn the quantity of possible future goods.

Whereas Mises recognizes the distinction between present goods and future goods as a universal praxeological category, Selgin's attempt to conflate demand and time deposits (thus distinguish himself fundamentally from Mises) implies a denial that there is no such fundamental difference between present (existing) goods and future (not-existing) goods (or that their existence differs only in degrees). Contrary to Selgin, it is not a matter of degree but rather one of substance whether a car or a sum of money presently exists or not, and whether one person or someone else owns them. Either they exist or they don't exist, and either A owns them or someone else does. Accordingly, if a property title (demand deposit note) then states that one person is the owner of a present car or present money and no car or money exists, or the car or money is presently owned by someone else, this does not represent a degree of truth but a falsehood. Explains Mises (1978, p. 268):

> A depositor of a sum of money who acquires in exchange for it a claim convertible into money at any time which will perform exactly the same service for him as the sum it refers to has exchanged no present good for a future good. The claim that he has acquired by his deposit is also a present good for him. The depositing of money in no way means that he has renounced immediate disposal over the utility it commands.

See also the two following notes.

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reached and/or a contract is concluded demonstrates that it must be a valid—true or permissible—agreement and contract. Yet this view is not only false it is also incompatible with Rothbard's title-transfer theory of contract that these authors claim to have accepted. Agreements and contracts per se do not imply anything regarding their validity for the fundamental reason that agreements and contracts do not create reality, but rather presuppose it. More specifically, contracts do not bring property into existence, but rather recognize and transfer existing property. Hence, as in Rothbard's ethical system, the theory of property must precede the treatment of contracts. Contracts and contract theory presuppose and are constrained by property and property theory. That is, the range of possible (valid) contracts is limited and restricted by the existing quantity (stock) of property and the nature of things, rather than the other way around. Thus, agreements regarding flying elephants, centaurs, squared circles, of perpetui mobile, for instance, are invalid contracts. They cannot—by virtue of biological, physical, or mathematical law—be fulfilled, and are from the outset false and fraudulent.

While Selgin and White may acknowledge this, they fail to recognize that a fractional reserve banking agreement implies no lesser an impossibility and fraud than that involved in the trade of flying elephants or squared circles. In fact, the impossibility involved in fractional reserve banking is even greater. For, whereas the impossibility of contracts regarding flying elephants, for instance, is merely a contingent and empirical one (it is not inconceivable that in another possible world, somewhere and sometime, flying elephants may actually exist, thus making such contracts possible), the impossibility of fractional reserve banking contracts is a necessary and categorical one. That is, it is inconceivable—praxeologically impossible—that a bank and a customer can agree to make money substitutes (banknotes, demand deposit accounts) debts instead of warehouse receipts. They may say or certify otherwise, of course, just as one may say that triangles are squares. But what they say would be objectively false. As triangles would remain triangles and be different from squares, so money substitutes would still be money substitutes (titles to present money) and be distinct from debt claims (titles to not yet existing future goods) and equity claims (titles to existing property other than money). To say otherwise does not change reality but objectively misrepresents it.

In doing what Selgin and White believe clients and banks to have done—to agree to make warehouse receipts debt—the money depositor A receives from the bank B a claim to present *money*, rather than a debt or equity title. That is, A does *not* in fact give up ownership of the deposited money (as would have been the case if he had received a debt or equity claim from B). While A retains title to the money deposit, however, B does not treat A's deposit as a bailment, but rather as a loan, and enters it as an asset onto its own (B's) balance sheet (offset by an equal sum of outstanding demand liabilities). While this may appear initially to be merely a harmless accounting practice, it involves from the outset a misrepresentation of the real state of affairs.[8] Since both, B as well as A, count the same quantity of

[8]See on this point Rothbard (1983b). "How," asks Rothbard,

do these warehouse receipt transactions relate to the T-account balance sheets of the deposit banks? In simple justice, not at all. When I store a piece of furniture worth $5,000 in

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money simultaneously among their own assets, they have in effect conspired to represent themselves in their financial accounts as owning a larger quantity of property than they actually own: that is, they have become financial impostors.[9] Though fraudulent, this would not matter so much if everything were left at this. However, as soon as B acts as if things were the way he represents them on his balance sheet to be—as if the bank owned the deposited money and only had the obligation to redeem outstanding warehouse receipts on demand—mere misrepresentation is turned into misappropriation. If B, in accordance with this misrepresentation, lends out money, or more likely, issues additional warehouse receipts for money and lends these out to some third party C, in the expectation of eventually being repaid principal and interest, the bank becomes engaged in undue appropriation, because what it lends out to C—whether money or titles to money—is in fact not its (B's) own property but that of someone else (A). It is this fact—that the title transferred from B to C concerns property B does not own—that makes fractional reserve banking from the outset fraudulent.

It is not the case, as is claimed, that fraud (breach of contract) is committed only if B, the fractional reserve bank, is actually unable to fulfill all requests for redemption as they arise. Rather, fraud is also committed each time B does fulfill its redemption obligations. Because whenever B redeems a fractionally covered banknote into money (gold) (whenever a note holder takes possession of his property), it does so with someone else's money: if B redeems C's note, it does so with money owned by A, and if A wants his money too, B pays him with money owned by D, and so on. *Qua* defenders of fiduciary media and fractional reserve banking, Selgin and White would have to maintain that there is no breach of contract as long as B is able to fulfill its contractual obligations with *someone else's* property (money).

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warehouse, in law and in justice the furniture does not show up as an asset of the warehouse during the time that I kept it there. The warehouse does not add $5,000 to both its assets and liabilities because it in no sense owns the furniture; neither can we say that I have loaned the warehouse the furniture for some indefinite time period. The furniture is mine and remains mine; I am only keeping it there for safekeeping and therefore I am legally and morally entitled to redeem it any time I please. I am not therefore the bank's creditor; it doesn't owe me money which I may some day collect. Hence, there is no debt to show up on the Equity + Liability side of the ledger. Legally, the entire transaction is not a loan but a bailment. (pp. 88–89; also pp. 94–95)

Interestingly, while Selgin and White manifest a strong positivistic tendency (fractional reserve banking is recognized by the courts, so it must be all right; on this tendency see "The Issue of Fraud III" below), they do not come to terms with legal reality. For if money deposits are debt, why, then, don't the courts apply the same reasoning to all other fungible commodities such as wheat? Why are wheat warehouse receipts not considered a debt (but a bailment) by the courts? Why is this treatment peculiar to money and the banking business? Moreover, why is it that the courts, even if they falsely consider money deposits as debts, still insist that they are more than an ordinary debt, and the depositor's relation to the bank is not identical with that of an ordinary creditor? See Rothbard (1983, p. 275).

[9]See also Jevons (1905, pp. 206–12, 221), who lamented the existence of general deposits since it has "become possible to create a fictitious supply of a commodity, that is, to make people believe that a supply exists which does not exist." On the other hand, special deposits, such as "bills of lading, pawn-tickets, dock-warrants, or certificates which establish ownership to a definite object," are superior because "they cannot possibly be issued in excess of the good actually deposited, unless by distinct fraud." And Jevons concluded that "it used to be held as a general rule of law, that a present grant or assignment of goods not in existence is without operation."

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Yet this is patently wrong, and it stands in clear contradiction to Rothbard's title-transfer theory of contract that Selgin and White claim to have accepted. In accordance with Rothbard's contract theory, individuals are only entitled to make contracts regarding the transfer of *their own property*. In contrast, fractional reserve banking, by its very nature (even if it is practiced successfully), involves contracts concerning the transfer of *other people's property*. Hence, this practice—the issue of fiduciary media—is in principle (inherently) incompatible with the title-transfer theory of contract—and it turns out, not surprisingly, that it is Rothbard, and not his two interpreters, who ultimately demonstrates a better grasp of his own contract theory.

THE ISSUE OF FRAUD II: FRACTIONAL RESERVE BANKING AND FREEDOM OF CONTRACT

Murray Rothbard's classification of fractional reserve banking as fraud was the result of long and intensive study of ethics and property-rights theory in particular. Selgin and White rightly regard economics as intellectually independent and separate from ethics. It may be studied without any prior knowledge of property and property-rights theory. Yet they do not hesitate to make sweeping ethical pronouncements. In their moral defense of fractional reserve banking Selgin and White rarely mention property, let alone outline a theory of property. This results in a series of fundamental errors and problems: confusion regarding the distinction between property and property titles; confusion as to the (im-)possibility of something (property) being owned simultaneously by more than one owner; confusion concerning the logical priority of property and property theory vis-à-vis contract and contract theory; and confusion concerning the necessity of fulfilling one's contractual obligations with one's own property (not just anyone's).

These difficulties enter into the authors' discussion of the issue of "freedom of contract." Their argument is straightforward.

> If a bank does not represent or expressly oblige itself to hold 100 percent reserves, then fractional reserves do not violate the contractual agreement between the bank and its customer. . . . Outlawing voluntary contractual arrangements that permit fractional reserve-holding is thus an intervention into the market, a restriction on the freedom of contract which is an essential aspect of private property rights. (p. 87)

This passage reveals again Selgin and White's already noted ultra-subjectivism. According to this view, it is voluntary agreements that make for—constitute and define—a valid contract. However, valid contracts are agreements regarding the transfer of real property; hence, the range of valid contracts is in fact first and foremost constrained by the nature of things and property (and only then by agreement). It was thus that Hoppe (1994, p. 70) explained that

> freedom of contract does not imply that *every* mutually advantageous contract should be permitted. . . . Freedom of contract means instead that A and B should be allowed to make any contract whatsoever *regarding their own properties*, yet fractional reserve banking involves the making of contracts regarding the property of third parties.

Selgin and White refer to this charge somewhat misleadingly as "third-party effects" (p. 92) and counter it by charging Hoppe in turn with elementary confusion as regards the nature of property and property rights. They state first, that

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> spill-overs from others' actions to the *value* of C's property . . . are an inescapable free-market phenomenon, and are not a violation of C's private-property rights, [whereas] *physical invasions* of C's property . . . are of course inconsistent with the protection of C's property rights. It should be obvious that if A and B are barred from any transaction that merely affects the *market value* of C's possessions, without any physical aggression or threat against C or C's rightful property, then the principles of private property, freedom of contract, and free-market competition are completely obliterated. Is B to be barred from offering to sell compact disc recordings to A, merely because doing so reduces the market value of C's inventory of vinyl records? (pp. 92–93)

Second, they state that the reduction of the purchasing power of money, which they admit must result from every issue of fiduciary media, is as such a harmless value-effect and thus "provides no justification for legally barring the bank's action." Hence they conclude that Hoppe's argument is "invalid" (and incompatible with Rothbard's theory of property).

Selgin and White's counterargument contains two errors. First, while the major premise is correct, it is false that Hoppe is mistaken about it. Hoppe has written extensively on the theory of property rights, and is not only aware of the distinction mentioned by Selgin and White but even provides a praxeological defense of it; hence, in this regard no difference of judgment whatsoever between Rothbard and Hoppe exists.[10]

Second, the minor premise is demonstrably false (and hence, so is the conclusion). Selgin and White claim that the fall in the purchasing power of money resulting from the issue of fiduciary media is the same sort of harmless event as a fall in the price of anything else (caused by changes in supply and/or demand). That money owners lose purchasing power as a result of fractional reserve banking, they claim, is not different from the situation in which the owners of potatoes or cars suffer a value-loss due to a larger supply of or a reduced demand for potatoes and cars.

Here again, Selgin and White conflate money (gold)—that is, property—and money substitutes (banknotes)—that is, property titles. To be sure, the issue of fiduciary media does not lead to physical damage to real property. After all, a bank note is just a piece of paper, and paper does not exert any relevant physical effect on the external world. But the same can be said also about the issue of fiduciary titles to potatoes or cars (titles backed by assets other than potatoes or cars). They, too, are merely pieces of paper, and as such have no impact on the real world. Yet there exists an important difference between changes in a potato or car owner's wealth position due to changes in the supply or demand for potatoes or cars on the one hand, and changes brought about by changes in the supply or demand for titles to non-existing (unchanged) quantities of potatoes or cars on the other hand. Surely, the owners of potatoes or cars are affected differently in both cases. In the first case, if the price of potatoes or cars falls due to a larger potato or car supply, all current potato or car owners remain (unchangingly) in possession of the same quantity of property (potatoes or cars). No one's physical property is diminished. Likewise, if the price falls because potato or car buyers are willing to offer only lesser quantities of other

[10]See, for instance, Hoppe (1988, pp. 69ff); and White's (1990) review of Hoppe.

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goods in exchange for potatoes or cars, this by itself has no effect on any current potato or car owner's physical quantity of potatoes or cars. In distinct contrast in the second case, the issue and sale of an additional title to an unchanged quantity of potatoes or cars *does* lead to a quantitative diminution of some current potato or car owner's physical property. It does not merely have a value-effect: the purchasing power of potato or car titles will fall. It does have a physical effect: the issuer and seller of fiduciary potato or car titles misappropriates other people's potatoes or cars. He appropriates other people's property without relinquishing any property of his own (in exchange for an empty property title).[11]

THE ISSUE OF FRAUD III: THE "PROOF FROM EXISTENCE" FRACTIONAL RESERVE BANKING AND STATE FORMATION

Neither the title-transfer theory of contract nor the principle of freedom of contract supports the claim that the issue of fiduciary media and fractional reserve banking is ethically justified. To the contrary, only one other argument remains in support of the claim that fractional reserve banking represents a legitimate form of business.

The argument boils down to a proof from existence: X, Y, or Z exists; it would not exist if it were not beneficial; hence, it should exist (and outlawing it would be detrimental and morally wrong).

Thus, write Selgin and White (p. 95):

> the group [of people] whose freedom of contract we are concerned with here is not a small eccentric bunch, but is the great mass of people who have demonstrated that they do prefer banks that operate on fractional reserves. . . . Depositors continue to patronize these banks, demonstrating their preference, for them. . . . By the principle of demonstrated preference depositors must be presumed to benefit from the package they have agreed to accept, risk and all. (p. 93)

> [Consequently,] if any person knowingly prefers to put money into an (interest-bearing) fractional reserve account, rather than into a (storage-fee-charging) 100 percent reserve account, then a blanket prohibition on fractional reserve banking by force of law is a binding legal restriction on freedom of contract in the market for banking services. (p. 88)

> [Moreover,] . . . benefits accrue to bank depositors and noteholders, who receive interest and services paid for by the extra bank revenue generated from lending out a portion of its liabilities. Benefits accrue to bank borrowers who enjoy a more ample supply of intermediated credit, and to everyone who works with the economy's consequently larger stock of capital equipment. And the benefits must accrue to bank shareholders, who could choose to have the bank not issue demand liabilities if they found the risks not worth taking. (p. 94)

Selgin and White have here put the cart before the horse. The existence of a practice, however widespread, has no bearing on the question of whether it is justifiable

[11] Also see note 4 above. We will also show that these authors' meaning of demand for (and supply of) money is misconceived. An increased demand for money (or potatoes or cars) is not just a wish to have more money (or potatoes), but greater *effective* demand.

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or not. Consider first, for illustrative purposes, the following analogy concerning the ethical permissibility of a state, that is, of a territorial monopolist of law and order (or of justice and protection).[12]

In the words of Selgin and White (applied here in a different context and paraphrased), the group of people whose freedom of contract we are concerned with is not a small eccentric bunch, but is the great mass of people who have demonstrated that they do prefer states (judges and protectors) that operate on a monopolistic basis. Territorial inhabitants continue to patronize these states, demonstrating their preference for them. By the principle of demonstrated preference, territorial inhabitants must be presumed to benefit from the package they have agreed to accept, risk and all. Consequently, if any person knowingly prefers to put money into a tax-bearing state account, rather than into a protection-fee-charging account in non-taxing justice and protection agencies, then a blanket prohibition on state-formation by force of law is a binding legal restriction on freedom of contract in the market for justice and protection services. Moreover, benefits accrue to state depositors and noteholders, who receive interest and services paid for by the extra state revenue generated from employing parts of the deposits for extra tax collections. Benefits accrue to state borrowers who enjoy a more ample supply of intermediated credit, and to everyone who works with the economy's consequently larger stock of capital equipment. And benefits must accrue to state shareholders, who could choose to have the state not engage in taxation if they found the risks not worth taking.

Given their own libertarian credentials, Selgin and White would presumably reject this analogy as false and inappropriate. But if so, why? What is it that invalidates the second *proof*, but not the first? What, if anything, makes a blanket prohibition (or permission) of fractional reserve banking categorically different from a blanket prohibition (or permission) of state formation and operation?

The answer—that no such difference exists and that both proofs are equally invalid—is to be found in the Rothbardian principle of demonstrated preference. While Selgin and White invoke this principle in support of their conclusion regarding the ethical permissibility of fractional reserve banking, they miss its implication. The principle of demonstrated preference, as explained by Rothbard in his celebrated "Toward a Reconstruction of Utility and Welfare Economics," *presupposes* property rights. Not all demonstrated preferences are ethically permissible or socially beneficial. Instead, the only such preferences that are permissible and welfare enhancing are these that are expressed by means of one's own property and nothing but one's own property. Every preference demonstration by means of property other than one's own—with other people's property—is impermissible and non-beneficial.

As for the demonstrated preference for states, it runs afoul of Rothbard's principle. In Rothbard's analysis, which is presumably accepted by the participants on

[12]To avoid any misunderstanding, the term monopoly is employed here in its Rothbardian definition as an exclusive privilege (or the absence of free entry). A monopoly of law and order means that one may turn for justice and protection only to one party—the state—and that it is exclusively this party that determines the content of justice and protection.

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both sides of the current debate, the violation can be quickly pinpointed. Private property, as the result of acts of (original) appropriation and/or production, implies the owner's right to exclusive jurisdiction regarding his property, including the right to employ this property in defense against possible invasions and invaders. Indeed, there can be no property without an owner's right to physical defense, and it is the very purpose of private property to establish separate domains of exclusive jurisdiction. No private-property owner can possibly surrender his right to ultimate jurisdiction over and defense of his property to someone else—unless he sells or otherwise transfers his property (in which case someone else would have exclusive jurisdiction over it). That is, so long as something (a good) has not been abandoned, its owner must be presumed as retaining these rights; and as far as his relations to others are concerned, every property owner may then only partake in the advantages of the division of labor and seek better and improved protection of his unalterable property rights through cooperation with other owners of property. Every property owner can buy from, sell to, or otherwise contract with everyone else concerning supplemental property protection and security services. Yet each owner also may at any time unilaterally discontinue any such cooperation with others. In distinct contrast, a territorial monopoly of protection and jurisdiction—a state—implies that every property owner is prohibited from discontinuing his cooperation with his protector, and that no one (except the monopolist) may exercise ultimate jurisdiction over his own property. Rather, everyone except the monopolist has lost his right to defense and is thus rendered defenseless vis-à-vis his own protector. Obviously, such an institution stands in contradiction to every owner's demonstrated preference of not giving up his property. Contrary to their demonstrated preference, the monopolist prohibits the people from using their property in physical defense against possible invasions by himself and his agents. A monopoly of protection and jurisdiction rests thus from the outset on an impermissible act of expropriation (taxation) and provides the monopolist and his agents with a license to further expropriation and taxation. Every owner's range of permissible actions regarding his own property, and hence the value of his property, is diminished, whereas the monopolist's range of action and control is correspondingly enlarged and his exclusive privilege is reflected in an increase in the value of his property (capitalization of monopoly profit).

Presently, states exist everywhere, and almost everyone resides under state *protection*. Regardless of this preference demonstration, however, there is nothing wrong, ethically or economically, with blanket protection against state formation. No one may form a state, for the same reason that no one may expropriate or rob anyone else. In a court of law, it would be sufficient that a single property owner objected to the monopoly's existence, and the monopolist would have to cease in his current operation as a tax-yielding protection agency and be repaired to the legal status of a non-taxing but fee-charging law-and-security agency (a normal specialized firm). A tax-yielding protection agency is a contradiction in terms—an invasive protector—and must be forbidden, irrespective of any benefits occuring to state depositors, state borrowers, and state owners. To do so is not a legal restriction on freedom of contract in the market for justice and protection services, but the very presupposition of freedom of contract and justice. Everyone putting money or any other resources into a tax-yielding protection account is engaged in unlawful action and subject to punishment.

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Just as states exist everywhere, so do fractional reserve banks, and nowadays practically everyone is banking with fractional reserve banks. What, if anything, is the difference between the status of a state and that of a fractional reserve bank? Why should fractional reserve banks not be outlaw banks just as states outlaw protection agencies? To be sure, just as there can be no doubt concerning a demand for protection services, there can also be no doubt as to a demand for banking services. Yet the demand for protection services that private-property owners may properly demonstrate does not include a demand for tax-yielding protection services, as we have seen. It exclusively permits a demand for fee-charging protection agencies. Why should an analogous distinction not be true also for banking services? Why should a demand for interest-yielding demand deposit accounts not be just as impermissible as the demand for tax-yielding protection accounts, on the ground that both interest-yielding deposit accounts and tax-yielding property protection are contradictions in terms? Why should the functions of a money warehouser and clearing institution (100 percent reserve deposit banking) and as an intermediary of credit (savings-and-loan banking) not be the only just forms of banking (just as fee-charging protection agencies are the only legitimate form of protection)?

The answer depends on whether or not the demonstrated preference for fractional reserve banking services, that is, the issue and acceptance of fiduciary media, involves solely and exclusively the property of the two contracting parties. At any given point in time, the quantity of property (appropriated goods)—whether consumer goods, producer goods, or money—is given. Fractional reserve banking does not increase the quantity of existing property (money or otherwise), nor does it transfer existing property from one party to another. Rather, it involves the production and sale of an increased quantity of titles to an unchanged stock of money property (gold); that is, the supply of and the demand for counterfeit money and illegitimate appropriation. As in every other case of counterfeiting (forgery)—of stock and commodity certificates, banknotes, land titles, original art, etc.,—the issue and sale of money copies (banknotes) uncovered by originals (gold) will physically diminish or despoil the original money—stock, commodity, land, or art—owners' property. But a counterfeiter of money is particularly dangerous and invasive because of money's defining characteristic as the most easily saleable and widely acceptable of all goods; that is, because *money*-counterfeits open to their seller the widest possible range of objects for undue appropriation (from money to almost every other form of real property).

Thus, it is no wonder that of all forms of forgery, the counterfeiting of money has always held the greatest attraction. So long as money exists there will also exist a persistent demand for counterfeit money. Regardless of this attraction and demand, however, there is nothing wrong with a blanket prohibition against fractional reserve banking. No one may operate a fractional reserve bank for the same reason that no one, in any other line of business, may engage in counterfeiting, that is, the production and sale of titles or copies to non-existing property or originals. In a court of law, it would be sufficient that a single money or other property owner brought suit against a fractional reserve bank as a manufacturer of counterfeit money, and the bank immediately would have to cease its current operation and be reduced to its two original functions: deposits and loans. An interest-yielding (rather than fee-charging) deposit bank is a contradiction in terms: it is a counterfeiting money warehouser,

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and must be outlawed, irrespective of any benefits accruing to bank depositors, borrowers, and owners. To do so is not a restriction on freedom of contract in the market for banking services, but the requirement of lawful money and banking. Everyone putting money or other resources into interest-yielding deposit accounts is engaged in undue and unlawful appropriation.[13]

The relationship between states and fractional reserve banks is even more intimate, and in any case quite different from that suggested by Selgin and White. They claim that it would be an illegitimate interference with the operation of free markets if the state were to prohibit fractional reserve banking. In fact, fractional reserve banking is the result of an illegitimate state interference with the market, and prohibiting it would only repair this earlier intervention. Selgin and White recognize that in the evolution of a free banking system, 100 percent reserve deposit banking and, functionally separated, loan banking, must (praxeologically) precede fractional reserve banking. In their view, fractional reserve banking is the natural outgrowth of an earlier 100 percent reserve system. However, they do not offer an explanation for this transition as a natural solution to a problem that cannot be solved under the prior system of 100 percent banking (in the way that Austrians conceive of money as the natural solution to the problem of lacking coincidences of wants under a preceding barter system). They merely affirm that the transition actually occurred.

While one can easily see why and how a banker might want to take advantage of the possibilities of counterfeiting, it is just as clear that any such attempt would not go by without quickly and continually being challenged. Surely the current writers and thousands of earlier legal and economic theorists would have accused fractional reserve banks of counterfeiting and would have brought suit against them. The further course of banking evolution would then depend on a court decision. If the court decided that the issue of fiduciary media *qua* titles to money uncovered by money constitutes counterfeiting, fractional reserve banks would not come into existence; and only if it decided otherwise would they ever actually appear. Nothing in this evolution is natural; everything appears rather deliberate. Nor would the outcome of such trials naturally be to Selgin and White's liking. To the contrary, if one were to assume that fractional reserve bankers would be tried on counterfeiting charges before a jury of their own peers (of other businessmen), we dare say that, empirically, the overwhelming number of such cases would end in conviction (the testimony of Selgin and White notwithstanding). Why, then, the almost complete dominance of fractional reserve banking?

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[13]Explains Rothbard (1995, p. 77):

> The champions of free competition in counterfeiting retort that this is simply the market at work, that the market registers a "demand" for more expanded credit, and that the private bankers, those Kirznerian entrepreneurs, are simply "alert" to such market demands. Well, of course, there is always a "demand" for fraud, and embezzlement, on the market, and there will always be plenty of "alert" swindlers who are eager and willing to furnish a supply of these items. But if we define the "market" not simply as a supply of desired goods and services, but as a supply of such goods *within* a framework of inviolate property rights, then we see a very different picture.

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The answer is that the courts deciding these matters everywhere are *state* courts. Only if a single court possesses a territorial monopoly of jurisdiction is it possible that the dispute at hand could be settled once and for all. And that it has been uniformly settled in the way it was, that is, by permitting rather than prohibiting fractional reserve banking, follows from the interest of every court and judge *qua* state court and state judge. The owners and agents of the state recognize fully as much as bankers the potentials of money counterfeiting as a source of income. In permitting bankers to issue fiduciary media (rather than prohibiting the practice as counterfeiting), banks are made existentially dependent on the state. They can only operate because the state, due to its territorial monopoly of jurisdiction, shields them from counterfeiting suits; and the state does so only under the provision that banks will share with it in the extra revenue and credit derived from legalized counterfeiting. Hence, by permitting fractional reserve free banking the state actually creates the first and preliminary form of a joint-bank-state-counterfeiting cartel under its own ultimate control.

Once fractional reserve banking receives blanket protection from the state, it follows naturally that fractional reserve banks will outcompete 100 percent reserve banks. Not, as Selgin and White assert (pp. 97–98), because they are better or more efficient banks, but for the reason that, once money counterfeiting is permitted, banks that engage in it tend to outcompete banks that do not. That is, for the same reason that, once industrial air pollution is permitted a polluting steel producer will tend to outcompete a steel producer who does not pollute, and for the same reason that a protection agency with taxing powers, a state, will tend to outcompete protectors without taxing power. Put differently, it is not always the case that good drives out bad. This is the case only so long as private property-rights are inviolate. If they are not, and there exist privileged agents or agencies, who are exempt from the universal rules regarding the appropriation, production and transfer of property, then these will tend to outcompete other normal agents. In this case, bad drives out good. Thus, it is completely mistaken to interpret the empirical success of fractional reserve banking as proof of its greater economic efficiency. The success of fractional over 100 percent deposit banking is no more a market phenomenon than is the success of tax-yielding protectors, states, over competitive and non-taxing security producers. It is false to suggest, as Selgin and White do, that fractional reserve banking has stood the market test and represents the outcome of voluntary consumer choices. After all, 100 percent reserve deposit banking is not outlawed and consumers are free to bank with them instead of fractional banks if they so prefer. Or would they likewise argue that the polluting steel producer had stood the test of the market because, after all, consumers are free to buy their steel from non-polluting steel producers, or that states have proven themselves in the market because, after all, consumers are free to buy their security also from agencies without any tax and jurisdictional powers?[14]

[14]A similar confusion characterizes Selgin and White's view on the relationship between money proper (gold) and banknotes. They criticize Hoppe for claiming that, in a genuine free-market order, most people would use money proper rather than banknotes (without mentioning Hoppe's theoretical reason). "The facts," they claim, "are otherwise" (p. 99). Yet these facts—the historical success of the banknote over genuine money—are the *result of an earlier state interference* with private-property rights (the legalization of fractional reserve banking). As Mises (1966, pp. 438, 442, 447) noted,

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Moreover, whereas 100 percent reserve banking is crisis-proof, fractional reserve banking, as even Selgin and White admit, is not. In fact, as we can only briefly indicate here, a system of free fractional reserve banking will, in accordance with Mises's theory of interventionism, lead to further state interventions and the successive devolution of money. Free fractional reserve banking *qua* state-protected competition in counterfeiting will lead to a steady contest among banks of testing the viability of increasingly lower reserve ratios. This is bound to lead to banking crises, and these will be used by governments for the introduction of central banking. Central banking leads to still more counterfeiting, and to the abolition of commodity money and adoption of national fiat currencies. Lastly, international—inter-central bank—competition in fiat money counterfeiting will lead to state bankruptcies, and their financial default will be used by the most powerful among the surviving states for the establishment of a one-world government, central bank, and fiat currency.

Hence, the solution proposed by Selgin and White to the current monetary disorder, that is, a gold-based free—fractional reserve—banking system, is in fact the initial interventionist cause of virtually all contemporary monetary problems.[15]

> the truth is that, except for small groups of businessmen who were able to distinguish between good and bad banks, banknotes were always looked upon with distrust. It was the special charters which governments granted to privileged banks that slowly made these suspicions disappear.
>
> In [governments'] eyes the foremost task of the banks was to lend money to the treasury. The money-substitutes were favorably considered as pace-makers for government-issued paper money. The convertible banknote was merely a first step on the way to the nonredeemable banknote. With the progress of statolatry and the policy of interventionism these ideas have become general and are no longer questioned by anybody.
>
> Governments did not foster the use of banknotes in order to avoid inconvenience to ladies shopping. Their idea was to lower the rate of interest and to open a source of cheap credit to their treasuries. In their eyes the increase in the quantity of fiduciary media was a means of promoting welfare. Banknotes are not indispensable. All the economic achievements of capitalism would have been accomplished if they had never existed.

Accordingly, Mises's view regarding sound money is completely different from Selgin and White's. Whereas the latter believe that gold would—and should—ultimately disappear from circulation altogether (see note 3 above), Mises (1978, pp. 450–51) considered it a requirement of a sound monetary system that "gold must be in the cash holdings of everybody. Everybody must see gold coins changing hand, must be used to having gold coins in his pockets, to receiving gold coins when he cashes his pay check, and to spending gold coins when he buys in a store."

[15]On the relationship between state, money and banking, and political centralization see Hoppe (1990) and Hülsmann (1997). Selgin and White argue:

> We also reject the notion . . . that *competitive* banks issuing redeemable liabilities can create credit "out of thin air." By the nature of the balance sheet, all bank loans must be funded by liabilities or equity. Neither source of funds can be conjured out of thin air. No one is forced to hold a bank's redeemable liabilities or to buy its shares; anyone can hold claims on other banks instead, or on no bank. A competitive bank must therefore *expend real resources to attract a clientele* by the provision of interest and services. The notion that a bank can extend credit gratuitously is valid only with respect to the inframarginal credits of a monopoly bank, or to the issuer of a forced tender; it does not apply to a bank in a competitive system. (p. 94, n. 13)
>
> Thus competition will beat down the returns to capital invested in fractional reserve banking until the marginal bank is earning only the normal rate of return. (p. 97)

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THE POSITIVE ECONOMICS OF FIDUCIARY MEDIA: MONEY BALANCE, PRICE ADJUSTMENT, SAVING, AND INVESTMENT

From the nature of fiduciary media—as titles to non-existing quantities of money property (gold), titles to money covered by things other than money, or plain counterfeit money—it would seem to follow that fractional reserve banking cannot possibly effect anything but a continual wealth and income redistribution. As the uncovered money substitutes ripple from the issuing bank and its borrower clientele outward through the economy, and thereby successively raise the price of increasingly more goods, real wealth (property) is transferred and redistributed in favor of the issuing bank and the initial and early recipients and sellers of this money, and at the expense of its late or never receivers and sellers. Explains Rothbard (1993, p. 851),

> the first receivers of the new money gain the most, the next gain slightly less, etc., until the midpoint is reached, and then each receiver loses more and more as he waits for the new money. For the first individuals' selling prices soar while buying prices remain almost the same; but later, buying prices have risen while selling prices remain unchanged.

However, according to Selgin and White, fiduciary media can accomplish far more. Rather than only redistributing existing property, the issue of fiduciary media can, under certain conditions, lead to an increase in real wealth (property). We have already quoted them stating that "benefits accrue to bank borrowers who enjoy a more ample supply of intermediate credit, and to everyone who works with the economy's consequently larger stock of capital equipment." They refrain from putting it this bluntly, yet what they claim is that, under specific circumstances, an

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While we have no difficulty accepting the distinction drawn here between competitive and monopolistic banking, none of this has any bearing on the issue at hand, that is, the validity of the analogy between states and fractional reserve banks as outlaw organizations. For one, states to compete for clients (residents). Indeed, competition between states (or banks) for clients only comes to a complete halt with the establishment of a single world state (or central bank). And the intra-state competition between fractional reserve banks is, as explained, competition within a state-privileged industry, that is, monopolistic competition (just as inter-state competition is an example of monopolistic competition). Second and more importantly, the difference between competitive and monopolistic banks (or states), interesting as it may otherwise be, does not affect in the slightest their common characteristic as fractional reserve banks (or states). Counterfeiting and taxation do not change their nature because they are undertaken competitively.

The error can be revealed by analogy. Selgin and White are paraphrased here: We also reject the notion that competitive states issuing tax liabilities can create taxes out of thin air. By the nature of state budgets, all expenditures must be funded by conquest, robbery, or theft. Neither source of funds can be conjured out of thin air. No one is forced to hold any particular state's tax liabilities or buy its shares; anyone can move and pay taxes to another state, or to no state. A competitive state must therefore *expend real resources to* attract a clientele by the provision of protection and services. The notion that a state can increase taxes gratuitously is valid only with respect to the inframarginal taxes of a monopoly state; it does not apply to a state in a competitive system. Thus, competition will beat down the returns to capital invested in states until the marginal state is earning only the normal rate of return.

According to Selgin and White, it would seem to follow that taxation (like money counterfeiting) is not to be considered a problem until the arrival of a single world monopoly bank. Up until then, under competitive conditions, taxes represent nothing but a normal market income.

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increase of titles to an unchanged fund of goods will somehow make this fund grow or prevent it from shrinking.

When and how can such a miracle be accomplished? According to Selgin and White, (unanticipated) changes in the demand for money lead to "temporary" or "short-run monetary disequilibrium" involving "serious misallocations of resources"—that is, *unless* such changes are accommodated by fractional reserve banking practices (p. 101). They write:

> In the long run, nominal prices will adjust to equate supply and demand for money balances, whatever the nominal quantity of money. It does not follow, however, that each and every change in the supply of or demand for money will lead at once to a new long-run equilibrium, because the required price adjustments take time. They take time because not all agents are instantly and perfectly aware of changes in the money stock or money demand, and because some prices are costly to adjust and therefore "sticky." It follows that, in the short-run (empirically, think "for a number of months"), less than fully anticipated changes to the supply of or demand for money can give rise to monetary disequilibrium. . . . It is therefore an attractive feature of free banking with fractional reserves that the nominal quantity of bank-issued money tends to adjust so as to offset changes in the velocity of money. (pp. 100–1)

> If the banking system fails to increase the quantity of bank-issued money and the price level does not promptly drop, an excess demand for money arises (assuming also that the quantity of base money does not immediately increase). A corresponding excess supply of goods arises: unsold consumer goods pile up on sellers' shelves (this is of course what proximately puts downward pressure on prices, until at last goods prices have fallen sufficiently). Business is depressed until the purchasing power of money gets back to equilibrium. (p. 105)[16]

From the outset, one must wonder about the very existence of the problem of monetary disequilibrium (not to speak yet about the solution). In the just-given quote, one can substitute any other good for money: televisions, steel, beer, or pretzels. The quantities of goods such as these are also rigidly fixed (as is the quantity of gold), and yet (unanticipated) changes in the demand for televisions, steel, beer, or pretzels do not lead to temporary disequilibria involving serious misallocations of resources. Or, in any case, they do not cause problems that would require the invention of a special new device (such as fractional television or beer production).

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[16] As Roger Garrision, another fractional reserve free banker, has put it, "in terms of the equation of exchange [MV=PQ], we can say that free banking adjusts so as to offset changes in V; but M allows changes in Q to be accomodated by changes in P." Garrison (1996, pp. 117–18) describes the short-run "monetary disequilibrium" in almost identical form:

> An increase in the demand for money puts downward pressure on product and factor prices in general. If there were no money-supply response, a general decline in economic activity would follow, since prices and wages could not fully and instantaneously adjust themselves to the new market conditions. Goods in general would go unsold; production would be cut; workers would be laid off. . . . With a less-than-perfectly flexible price system, general deflationary pressures can push the economy below its potential during the period in which prices are adjusting to the higher monetary demand. And the fact that some prices and some wages are more flexible than others means that the adjustment period will involve changes in relative prices that reflect no changes in relative scarcities. These are precisely the kinds of problems . . . avoided by free banking's responsiveness to increases in money demand.

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Nor is it clear why we are supposed to believe that "it is important to distinguish between short-run and long-run implications of changes in the demand schedule for money or in the stock of money" (p. 100), or, in any case, why this distinction should be of different importance or significance in the case of money from that of everything else. To be sure, it takes time before an unexpected increase in the demand for televisions and beer, for instance, will have exhausted all of its effects on the system of relative prices and a new adjusted production structure will have been established. But this does not mean that price adjustments take any time (meanwhile causing short-run problems). To the contrary, price adjustments occur immediately and without any delay. Every change in the supply of or demand for anything affects prices instantly. This fact is overlooked because of an un-Austrian concern for macroeconomic artifacts such as the general price level, long-run equilibrium, and the velocity of money. However, viewed from the proper individualist perspective, there can be no doubt about the immediacy of price adjustments and the praxeological integration of the short and the long run.

In individualistic terms, an increased demand for money is the result of the purposeful actions of individuals, that is people intent upon increasing their individual cash balances. To do so, a person must restrict his purchases and/or increase his sales. In either case, the outcome is an immediate fall of some prices. As the result of restricting one's purchases of x, y, or z, the money price of x, y, or z will be lowered immediately (as compared with what it would have been otherwise), and likewise, by increasing one's sales of a, b, or c their prices will fall instantly. No one is concerned about the general price level or the generalized purchasing power of money. Instead, everyone is always concerned about specific prices and the purchasing power of money regarding specific items (and everyone is interested in his very own and different specific array of prices and purchasing power). In restricting his specific purchases and/or increasing his specific sales, each actor accomplishes exactly and immediately what he wants: certain prices that he deems too high are lowered, the purchasing power of a unit of money increases, the real value of his cash balance rises, and his demand for and supply of money is immediately brought back into equilibrium (and he wishes to hold neither more nor less money than he actually does).[17]

The adjustment of the praxeologically meaningless general price level necessitated by an increased demand for money is nothing but the summation of a series of countless immediate and purposeful individual cash-balance adjustments. If the increased demand for money is accommodated by the issue of fiduciary media, as Selgin and White

[17]Thus writes Mises (1990, p. 61):

> Buyers and sellers on the market never concern themselves with the elements in the equation of exchange, of which two—velocity of circulation and the price level—do not even exist before market parties act and the other two—the quantity of money (in the whole economy) and the sum of transactions—could not possibly be known to the parties in the market. Only the importance which the various actors in the market attach, on the one hand, to the maintenance of a cash balance of a certain magnitude and, on the other hand, to the ownership of the various goods in question determines the formation of the exchange relationship between money and goods.

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advocate, this adjustment process will not be facilitated but delayed.[18] The speed of the adjustment of prices depends on the market-participants' expectations concerning the given quantity of money. If it is reasonable to assume that fractional reserve banks will increase their fiduciary issues in response to an unanticipated increase in the demand for money, then the adjustment will take *more* time. Production would adjust and begin *earlier* without the additional influence of inflation.[19]

Moreover, the proposed solution to the alleged problem of short-run monetary disequilibrium displays a fundamental confusion regarding the concept of demand (and supply), and the relationship between the demand for money, saving, and investment in particular. First, an increased demand for money (as for televisions, beer, or pretzels) is not just a wish to have more money (or televisions, beer, etc.), but *effective* demand. That is, an increased demand for money (as for anything else) can be satisfied only if the demander is willing to increase his market-supply of and/or reduce his demand for something else. Likewise, the supplier (seller) of money can only increase his supply of money if he reduces simultaneously the supply of (or his reservation demand for) something else. The authors have overlooked Say's law: all goods (property) are bought with other goods, no one can demand anything without supplying something else, and no one can demand or supply more of anything unless he demands or supplies less of something else. But this is here *not* the case whenever a fiduciary note is supplied and demanded. The increased demand for money is satisfied without the demander demanding, and without the supplier supplying, less of anything else. Through the issue and sale of fiduciary media, wishes are accommodated, not effective demand. Property is appropriated (effectively demanded) without supplying other property in exchange. Hence, this is not a market exchange—which is governed by Say's law—but an act of undue appropriation. Or would it be an efficient solution to the problem of unanticipated short-run television, beer, or pretzel-shortages if television, beer, and pretzel producers were to accommodate such increased demand

[18]Moreover, from an individualist perspective, the increased demand for money occurs with specific actors at specific times and places. It is not sufficient for banks to accommodate some abstract higher money demand by more money; rather, but the accomodation would have to occur precisely with the correct people and locations. If this is not the case, one can hardly speak of an accomodation but of an additional distortion. This difficulty was recognized by the early Hayek (1935, p. 124):

> in order to eliminate all monetary influences on the formation of prices, and the structure of production, it would not be sufficient merely quantitatively to adapt the supply of money to these changes in demand, it would be necessary also to see that it came into the hands of those who actually require it, that is, to that part of the system where that change in business organization or the habits of payment had taken place.

With the later Hayek, one wonders how banks could possibly have the requisite knowledge of performing this task.

[19]As regards the stickiness of prices, and the redistributive consequences of an increased demand for money vis-à-vis an array of prices of varying degrees of stickiness, which Selgin and White as well as Garrison raise as matters of concern, it is of utmost importance to recognize that prices are the outcome of purposive action—and so is their stickiness. That is, the flexibility or inflexibility of various product and service prices is not accidental to, but a deliberate part of, these products and services. Contrary to Garrison's claim, the stickiness of prices does affect and is related to, real relative scarcities. If more sticky prices suffer more, so to speak, so be it; that will teach them to be less sticky in the future—if the owners of the property in question act in a manner compatible with this end.

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"temporarily" by issuing and selling additional titles to televisions, beer, and pretzels but not these goods themselves?

Second,[20] Selgin and White further misconstrue the nature of money and the demand for money hold extraordinary claim: that the issue of fiduciary media *"matched by an increased demand to hold fiduciary media"* is not only not disequilibrating (p. 102), but will actually afford the economy a "larger stock of capital equipment," because

> the act of holding fractional-reserve *bank-issued* money not only (like holding base money) defers consumption for a longer or shorter period, but also *temporarily lends funds* to the bank of issue in doing so. The period of the loan is unspecified . . . but if the bank can estimate with a fair degree of accuracy the lengths of time for which its demand claims will remain in circulation . . . , it can safely make investments of corresponding length. (p. 103)

Following the lead of Rothbard, Hoppe had criticized this essentially Keynesian view concerning the relationship between the demand for money and savings (loanable funds)[21] by pointing out that

> not-spending money is to purchase *neither* consumer goods *nor* investment goods. . . . Individuals may employ their monetary assets in one of three ways: they can spend them on consumer goods; they can spend them on investment; or they can keep them in the form of cash. There are no other alternatives. . . . The consumption and investment proportion, that is, the decision of how much to spend on consumption and how much on investment, is determined by a person's time preference, that is, the degree to which he prefers present consumption over future consumption. On the other hand, the source of his demand for

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[20]The error of confusing property and titles lies also at the bottom of Selgin and White's attempts to separate analytically the demand for outside money from the demand for inside money, as if these were somehow two different kinds of money with two different and independent demands.

[21]Selgin (1988, p. 55) stated the same thesis thus:

> Whenever a bank expands its liabilities in the process of making new loans and investments, it is the holders of the liabilities who are the ultimate lenders of credit, and what they lend are the real resources they could acquire if, instead of holding money, they spent it. When the expansion or contraction of bank liabilities proceeds in such a way as to be at all times in agreement with changing demands for inside money, the quantity of real capital funds supplied to borrowers by the banks is equal to the quantity voluntarily offered to the banks by the public. Under these conditions, banks are simply intermediaries of loanable funds.

As for John Maynard Keynes (1936, p. 82) he had written in the *General Theory* that "the notion that the creation of credit by banking system allows investment to take place to which 'no genuine saving' corresponds" that is, "the idea that saving and investment . . . can differ from one another, is to be explained, I think, by an optional illusion" (ibid, p. 81). "The savings that result from this decision are just as genuine as any other savings. No one can be compelled to own the additional money corresponding to the new bank-credit, unless he deliberately prefers to hold more more money rather than some other form of wealth" (ibid, p. 83). Indeed, Selgin (1988, p. 59) acknowledges that "many Keynesians might accept the prescription for monetary equilibrium offered [by him]. Those who do not regard the liquidity trap as important factual possibility would probably accept it as entirely adequate."

Henry Hazlitt (1983, p. 227) remarked on this Keynesian idea that "on the same reasoning we can create any amount of new 'savings' we wish overnight, simply by printing that amount of new paper money, because *somebody* will necessarily hold that new paper money."

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> cash is the utility attached to money, that is, the personal satisfaction derived from money in allowing him immediate purchases of directly or indirectly serviceable consumer or producer goods at uncertain future dates.
>
> Accordingly, if the demand for money increases while the social stock of money is given, this additional demand can only be satisfied by bidding down the money prices of non-money goods. The purchasing power of money will increase, the *real* value of individual cash balances will be raised, and at a higher purchasing power per unit money, the demand for and the supply of money will once again be equilibrated. The relative price of money versus non-money will have changed. But *unless* time preference is assumed to have changed at the same time, *real* consumption and *real* investment will remain the same as before: the additional money demand is satisfied by reducing nominal consumption *and* investment spending in accordance with the same pre-existing consumption and investment proportion, driving the money prices of both consumer as well as producer goods down, and leaving real consumption and investment at precisely their old levels. (Hoppe 1994, pp. 72–73)

Accordingly, Hoppe concluded, it is *never* warranted to accommodate an increased demand for money by issuing fiduciary credit.[22] In fact, to do so will either —insofar as the accommodating increase of fiduciary media is unanticipated and the market rate of interest falls temporarily below the natural rate of interest—lead to a boom-bust cycle; or else—insofar as the monetary change arising from the banking system is anticipated and the market rate of interest is bid up (in the expectation of higher selling prices) in accordance with the height of the natural rate—it will accomplish no more than a plain wealth and income redistribution among various members of society. It is praxeologically impossible, however, that the issue of fiduciary media can lead to an "enlarged stock of capital equipment."

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[22] See also Hoppe (1993, pp. 119–20, 137–38); and Rothbard's (1993, pp. 167ff, 667ff; 1983a, pp. 39ff) original argument in *Man, Economy, and State*.

As for Selgin and White's claim of being Misesians, it is worthwhile to quote Mises on

> the role cash holding plays in the process of saving and capital accumulation. . . . If an individual employs a sum of money not for consumption but for the purchase of factors of production, saving is directly turned into capital accumulation. If the individual saver employs his additional savings for increasing his cash holding because this is in his eyes the most advantageous mode of using them, he brings about a tendency toward a fall in commodity prices and a rise in the monetary unit's purchasing power. If we assume that the supply of money in the market system does not change, this conduct on the part of the saver will not directly influence the accumulation of capital and its employment for an expansion of production. The effect of our saver's saving, that is, the surplus of goods produced over goods consumed, does not disappear on account of his hoarding. The prices of capital goods do not rise to the height they would have attained in the absence of such hoarding. But the fact that more capital goods are available is not affected by the striving of a number of people to increase their cash holdings. If nobody employs the goods—the nonconsumption of which brought about the additional saving—for an expansion of his consumptive spending, they remain as an increment in the amount of capital goods available, whatever their prices may be. The two processes—increased cash holding of some people and increased capital accumulation—take place side by side. A drop in commodity prices, other things being equal, causes a drop in the money equivalent of the various individuals' capital. But this is not tantamount to a reduction in the supply of capital goods and does not require an adjustment of production activities to an alleged impoverishment. It merely alters the money items to be applied in monetary calculation. (Mises 1966, pp. 521–22)

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In their attempt to rebut this argument, Selgin and White first concede the central theoretical point: "We agree that time preference and money demand are distinct, and that a change in one does not imply a change in the other" (p. 102). Likewise:

> that holding money is one form of saving does not imply that an increase in the demand for money is identically an increase in total saving. An increased demand for money may accompany a reduced demand for holding other assets, and not a reduction in consumption; hence it may be part of a change in the manner of saving with no change in total savings. (p. 103)

However, if an increased demand for money is *not* identically an increase in total savings, then it is impossible to maintain that it provides for a larger pool of loanable funds and increased capital formation (a lengthening of the structure of production). Hence, to rescue their economic-growth thesis, immediately following this concession Selgin and White try to take it back again by arguing that:

> Nonetheless [the non-identity of time preference and money demand notwithstanding], to hold money is to hold it for later spending, even though how much later is not signalled (and typically has not yet been decided by the money holder). Holding money for later spending, rather than spending it on consumption now, does defer consumption to the future. As Hoppe . . . himself points out, the demand for cash stems from the convenience it allows one in purchasing "consumer or producer goods at uncertain *future* dates." . . . So perhaps our disagreement here is merely over words. (p. 102)

Unfortunately, this suggestion is unfounded. Rather than a verbal quibble, the disagreement is a substantive one concerning the nature of money.

It is difficult not to interpret the two previous pronouncements as contradictory. Selgin and White try to escape from this conclusion by an *ad hoc* semantic shift, that is, in characterizing money as a *future* good. Essentially, their argument is that while increased money demand does not imply increased savings, it provides nonetheless for a larger loan fund, because money is held only to be spent "at uncertain *future* dates" (their emphasis), such that an increased demand for money is always and at the same time an increase in the demand for future goods.[23] Yet money is demonstrably *not* a future good. In fact, when the money is spent—in the future—it loses all its utility for the present owner. It has utility only while and insofar as it is *not* spent, and its character as a present good stems from the omnipresent human condition of *uncertainty*.[24]

The error in classifying money as a future good can be revealed in a twofold manner. On the one hand, negatively, it can be shown that this assumption still leads to contradiction. In support of their thesis, Selgin and White claim that "holding

[23]Selgin and White's view here is quite similar to that of Keynes (1936, pp. 293–94), when he emphasized that "the importance of money essentially flows from its being a link between the present and the future," and characterized money as "above all, a subtle device for linking the present and the future."

[24]Put differently: rather than, as Selgin and White say, that "the demand for money stems from the convenience it allows one in purchasing goods at uncertain *future* dates," the demand for money stems from the convenience it allows one in purchasing goods at *uncertain* future dates.

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money for later spending, rather than spending it on consumption *now*, does defer consumption to the future," implying that the holding of money involves the exchange of a future good (satisfaction) for a present one. In the next sentence they admit that money held is spent *neither* on consumer goods *nor* on producer goods. Yet they fail to notice that this implies also, as a further consequence, that holding money for later spending, rather than spending it on production *now*, does defer *production* (and hence *future* consumption) to the future. If the holding of money defers consumption *and* production, however, then it becomes impossible to maintain that the holder of money has thereby invested in a *future* good, because *there are no future goods*—whether consumer *or* producer goods—which result from the act of holding money and to which its holder could thus be entitled. Yet as claims to no future goods whatsoever, money would be worthless. By implication, if money is not worthless (and no one would hold money if it had no value), then its value must be that of a *present* good.

On the other hand, positively, the nature of money as a paradigmatically present good can be established by praxeological proof. As Mises and Rothbard have explained, in general equilibrium or, more appropriately, within the imaginary construction of an evenly rotating economy, no money exists. With all uncertainties by assumption removed, everyone would know precisely the terms, times, and locations of all future exchanges, and all exchanges could be prearranged accordingly and take the form of direct rather than indirect exchanges.

> In a system without change in which there is no uncertainty whatever about the future, nobody needs to hold cash. Every individual knows precisely what amount of money he will need at any future date. He is therefore in a position to lend all the funds he receives in such a way that the loans fall due on the date he will need them. (Mises 1966, p. 249)

While there is no place for money in the construction of an evenly rotating economy, however, there exists within its framework a present and a future, now and later, the beginning of an action and its later completion, immediately serviceable consumer goods (present goods) and indirectly serviceable producer goods (future goods), a structure of production, and savings and investment, that is, exchange of present against future goods governed by time preference. If anything, this proves again that money and the demand for money are systematically unrelated to consumption, production, and time preference, and that the source of the utility of money must be a categorically different one from that of consumer goods and producer goods. The source of the utility of a consumer good is its direct and present serviceability, and the source of the utility of a producer good is its indirect future serviceability. Money, by contrast, is neither consumed nor employed in production. It is neither directly serviceable (as consumer goods are) nor indirectly useful as a way station to future consumer goods (as producer goods are). Rather, the utility of money must be that of an *indirectly yet presently* serviceable good.

Outside the imaginary construction of an evenly rotating economy, under the inescapable human condition of uncertainty, when the terms, times, and locations of all future exchanges cannot be predicted with certitude, and when action is by nature speculative and subject to error, man can conceivably demand goods no longer exclusively on account of their use-value (present or future), but also because of their value as *media of exchange* (for resale purposes). Faced with situations

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where, due to the absence of double coincidences of wants, a direct exchange is impossible, man can evaluate goods also on account of their degree of marketability, and can consider trading whenever a good to be acquired is more marketable than that to be surrendered, such that its possession would facilitate the acquisition of directly or indirectly serviceable goods and services. Moreover, because it is the sole function of a medium of exchange to facilitate purchases of directly or indirectly serviceable goods, man will naturally prefer the acquisition of a more marketable and, at the limit, universally marketable medium of exchange to that of a less or non-universally marketable one, such that

> there would be an inevitable tendency for the less marketable of a series of goods used as media of exchange to be one by one rejected until at last only a single commodity remained, which was universally employed as a medium of exchange; in a word, money. (Mises 1978, pp. 32–33)

Selgin and White are familiar with this Mengerian–Misesian reconstruction of monetary evolution, of course. They apparently fail to recognize, however, that this feature of money as the most easily and widely saleable commodity, far from rendering it a future good, qualifies money at the same time as the good best suited to alleviate presently felt uncertainty and, as such, the most universally present good of all.[25] Although only indirectly useful—in this regard like producer goods, and unlike any consumer good—money is precisely on account of its supreme saleability a uniquely present good—in this regard like consumer goods, and unlike any producer good. Because money can be employed for the instant removal of the widest range of possible needs (or the satisfaction of the widest range of possible desires), it provides its owner with the best humanly possible protection (insurance) against uncertainty, that is, against his uneasiness of *not* being able to predict—of *not* being certain about—all of his future needs and desires. In holding money, its owner gains in the satisfaction of being able instantly to meet, as they arise unpredictably, the widest possible range of future contingencies.[26] "The maintenance of cash holding

[25]In fact, one can only wonder how Selgin and White could have possibly overlooked money's character as a uniquely present good. After all, the interest rate as the most visible manifestation of the phenomenon of time preference is expressed in terms of *money*.

[26]The term uncertainty is employed here in its technical meaning as defined by Knight (1971, esp. chap. 7) and Mises (1966, esp. chap. 6), that is, as categorically distinct from risk (instances of class probability); also Hoppe (1997). Insofar as man faces a risky future, he does not need to hold cash. In order to satisfy his desire to be protected against risks, he can instead buy (or produce) insurance. A buyer of insurance demonstrates by his purchase that he is in fact *certain* about some future events. Hence, in paying a premium, he sacrifices a present good in exchange for a future one (payment in the event of actual risk-damage) and so contributes to and invests in a physical structure of production. Specifically, his premium becomes embodied in the production structure maintained by his insurance agency. In distinct contrast: insofar as man faces uncertainty he is, quite literally, *not certain* concerning his future, that is, as to what will happen to him and when. Hence, in order to be protected against uncertainty, he cannot possibly invests in any future good. Only present goods can insure against instantly arising—unpredictable—events. Nor can he invest in (present) consumer goods (for this would mean that he actually felt certain as to the specific nature of his future contingencies). Only a medium of exchange, on account of its supreme saleability, can insure him against contingencies of an uncertain nature. Hence, just as insurance is the price that must be paid for protection against risks, so cash holdings are the price that must be paid for protection against uncertainty. See also the following final note below.

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requires sacrifices. To the extent that a man keeps money in his pocket or in his balance with a bank, he foresakes the instantaneous acquisition of goods he could consume or employ for production" (Mises 1966, p. 430). Accordingly, to the extent that he feels certain regarding his future, a man will want to invest in consumer and producer goods. Only to the extent that he feels uncertain about his future will he want to make the sacrifice referred to by Mises, that is, will he possibly want to invest in relief from any uneasiness felt concerning the uncertainty of his future consumption–production (income–expenditure) pattern. Hence, rather than indicating his increased willingness to sacrifice present satisfaction in exchange for future satisfaction, an increased demand for money demonstrates a man's more intensely felt uncertainty regarding his future; and rather than being an investment in the future, an addition to his cash balance represents an investment in present certainty (protection) vis-à-vis a future perceived as less certain.[27]

In light of this praxeological reconstruction of money as a singularly present good, Selgin and White's entire positive case for fractional reserve banking is revealed as mistaken. If banks indeed accommodate an (unanticipated) increased demand for money through the temporary issue of additional fiduciary media (credit), as Selgin and White propose, this can have only disruptive and disequilibrating effects. If and insofar as the accommodating response on the part of the banks is unanticipated, the interest rate will be reduced temporarily below its natural height, investment will increase, and the structure of production will be lengthened. Yet this result is fundamentally at odds with the public's demonstrated preference. The public perceives the future as more (increasingly) uncertain and, accordingly, in striving to increase the size of its cash holdings and thereby bidding the prices of non-money goods down and correspondingly increasing the purchasing power per unit money, is intent upon providing for more (increased) present protection against uncertainty. To commit additional resources to the future is the expression of *less* public uncertainty (rather than more), and thus stands at cross-purpose to the public's actual wishes and implies a systematic misallocation of resources (to be revealed in a boom-bust cycle). And in any case, even if the banks' accommodating money supply increase could be fully anticipated and the structure of production were not unduly lengthened, any such accommodation would still be disruptive, because—even apart from its inescapable redistributionist consequences—it can only *delay* the arrival of

[27] Selgin and White never raise the question of *why* changes in the demand for money occur, and thus never penetrate to their ultimate—microeconomic—sources, that is, changes in individuals' subjective evaluations of presently perceived personal uncertainty. In contrast, whereas they portray changes in the demand for money as seemingly unmotivated and inexplicable events, Mises is explicit and emphatic about their rational character:

> The advantages and disadvantages derived from cash holding are not objective factors which could directly influence the size of cash holdings. They are put on the scales by each individual and weighed against one another. The result is a subjective judgment of value, colored by the individual's personality. Different people and the same people at different times value the same objective facts in a different way. Just as knowledge of a man's wealth and his physical condition does not tell us how much he would be prepared to spend for food of a certain nutritive power, so knowledge about data concerning a man's material situation does not enable us to make definite assertions with regard to the size of his cash holding. (Mises 1966, p. 430)

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the desired goal. In order to be better protected against perceived uncertainty, prices must fall and the purchasing power of money must rise. With an additional influx of money, it cannot but take *longer* before this goal is accomplished.[28]

A FINAL NOTE: SOME MISTAKEN ANALOGIES

In light of the fundamental distinction between property (money) and property titles (money substitutes) explained in earlier sections of this article and the foregoing elucidation of money as a uniquely present good, several analogies popularly employed in the attempted justification of fractional reserve banking can be finally disposed of as mistaken. Even if they correctly distinguish between property titles (tickets) and property, all proposed analogies—between fractional reserve banking on the one hand and airline overbooking, fractional reserve parking lots, lotteries, and insurance on the other hand—fail to recognize properly the fundamental distinction between present and future goods.

The owner of a title to money owns a present good (money property)—an indirectly yet immediately serviceable good. The fractional reserve banker is found guilty of fraud; he issued and sold additional titles to an unchanged quantity of money property. In distinct contrast; the owner of an airline ticket owns a future good. Hence, in overbooking now (today) a flight at a future date (tomorrow), an airline cannot possibly have committed fraud already *now* (today). Fraud cannot occur until tomorrow, when the tickets must be actually redeemed, and only if the airline is then unable to satisfy each and every ticket holder's claim. In fact, airlines typically fulfill their contractual obligation: each ticket holder is assured a seat on the scheduled flight, because the airline is prepared to pay every excess ticket holder off, that is, to repurchase his ticket at a price (by exchange of another good) that the holder considers more valuable than his present airline seat. And certainly, no airline typically oversells spot-tickets (titles to seats right now, that is, present

[28]Mises summarizes:

> The services money renders are conditioned by the height of its purchasing power. Nobody wants to have in his cash holding a definite number of pieces of money or a definite weight of money; he wants to keep a cash holding of a definite amount of purchasing power. As the operation of the market tends to determine the final state of money's purchasing power at a height at which the supply of and the demand for money coincide, there can never be an excess or a deficiency of money. Each individual and all individuals together always enjoy fully the advantages which they can desire from indirect exchange and the use of money, no matter whether the total quantity of money is great or small. Changes in money's purchasing power generate changes in the disposition of wealth among the various members of society. From the point of view of people eager to be enriched by such changes, the supply of money may be called insufficient or excessive, and the appetite for such gains may result in policies designed to bring about cash-induced alterations in purchasing power. However, the services which money renders can be neither improved nor repaired by changing the supply of money. There may appear an excess or a deficiency of money in an individual's cash holding. But such a condition can be remedied by increasing or decreasing consumption or investment. (Of course, one must not fall prey to the popular confusion between the demand for money for cash holding and the appetite for more wealth.) The quantity of money available in the whole economy is always sufficient to secure for everybody all that money does and can do. (Mises 1966, p. 421)

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goods) and assigns two people to occupy the same seat, which is essentially what fractional reserve banking amounts to.

Similarly, the owner of a fractionally covered parking permit (with more permit holders than parking spaces) does not own a present good. He owns the right to participate for a specified period of time in repeated search for parking space. The owner of the parking facility cannot possibly commit any fraud in selling his permits, unless he then refused entry to a valid permit holder when there was empty space available, or if he changed the contractually agreed upon rules of the game; that is, if he had agreed to print up to a maximum of 200 permits, for instance, but actually printed 300. It is only the owner of a spot parking ticket, or the owner of a reserved parking space, who are owners of a present good; and there is, of course, characteristically no overselling of spot spaces or of reserved parking.

The same reasoning applies to the case of lotteries. The holder of a lottery ticket does not own any present good. He owns the right to participate in the drawing of specified prizes, whereby it is self-understood among buyer and seller—as inherent in the nature of a lottery—that there are—and must be—more tickets than prizes. The lottery operator cannot possibly have committed any crime, unless he failed to redeem the winning tickets into the promised prizes or surreptitiously changed the preannounced rules of the game. If this is rarely the case, it is practically unheard of that a lottery would print more than one winning ticket for one and the same prize (present good), which would be likewise fraudulent, of course, and which is essentially what fractional reserve bankers do.

Finally, the proposed analogy between fractional reserve banking and insurance has already been refuted implicitly in note 26 above, concerning the relationship between risk and insurance on the one hand and uncertainty and money on the other. Unlike the owner of money, the owner of an insurance policy does not own a present but a future good. An insurance company may be unable to meet its contractually assumed obligations at some future point in time, and one may then come to the conclusion that it had engaged in an overselling of tickets. However, it is impossible to say that a crime has been already committed now, at the moment when the insurance policy is sold, because the good sold by the insurance agency is a future one. In distinct contrast, the owner of a money ticket is the owner of a present good, and every overissue of tickets to present goods is from the very outset—instantly and immediately—fraudulent, and accordingly is contrary to market ethics.

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THE INTERTEMPORAL ADAM SMITH

ROGER W. GARRISON

On the 200th anniversary of the publication of the *Wealth of Nations*, James Buchanan (1976, p. 273) posed the question—somewhat rhetorically—"Is [Murray] Rothbard the modern analogue to Adam Smith?" His answer followed immediately: "Little or no exegesis is required to answer such a question emphatically in the negative." Significantly, Buchanan pointed to Rothbard's *For a New Liberty* (1973) rather than his *Man, Economy, and State* (1962) as the most telling contrast to Smith's *Wealth of Nations*. Absent in Rothbard and present in Smith is the notion of public benefits to collective action. Rothbard's "modern libertarian anarchism" (Buchanan's term) stands in contrast to Smith's classical liberalism.

Buchanan could hardly have been surprised at Rothbard's subsequent assessment of the putative Father of Economics, particularly when the economics of public goods and externalities is at issue. In fact, his own overall assessment of Smith on policy issues is very similar to Rothbard's. "[I]t is not difficult for us to imagine [Smith] constructing a catalogue of market abuses or failures and calling directly for corrective action" (Buchanan 1976, p. 278):

> he would have supported legislation for anti-monopoly action, for the definition of the monetary unit, for the regulation of banking, for public utility operation and/or regulation, for minimal public education, for standardized weights and measures, for grade labeling, for limited building codes, possibly for publicly supplied information and support for the arts.

Compare this list of interventions with the one offered by Rothbard (1995, p. 466), showing that in addition to advocating usury laws, Smith was an advocate of

> public education, regulation of bank paper, public works (including highways, bridges and harbors) government coinage, the post office, compulsory building of fire walls, compulsory registration of mortgages, some restrictions on the export of corn, and the outlawing of the practice of paying employees in kind.

According to West and others, Smith believed that capital accumulation has a public-goods character to it, or, equivalently, that it generates external benefits. It is a short step from this belief to the understanding that Smith recommended policies

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aimed at correcting for these perceived external effects. He favored a higher rate of capital accumulation—and hence a lower rate of present consumption—than would spontaneously occur in a market economy. Although the issues of public goods and external benefits are clearly discernible in the *Wealth of Nations* and provide a basis for a contrast with the writings of Rothbard, Smith's pro-growth policy recommendations are more straightforwardly understood, I have argued, as stemming from a fundamental value bias. People interacting with one another in a system of natural liberty systematically discount the future. Smith believed, or wrote as if he believed, that they should not do so. Policy should be aimed at overriding people's shortsightedness. In practice, rapid growth was simply taken to be an ultimate policy goal.

In two of the nine sections of his chapter on the "Celebrated Adam Smith," Rothbard (1995, chap. 16) makes some use of my "Comment" (Garrison 1985) on Edwin West's "Reappraisal" (1985) of the relationship between Richard Cantillon and Adam Smith. (West's paper and my comment were presented in August of 1980 at a Liberty Fund Symposium on Richard Cantillon; Rothbard was a participant at that symposium.) Rothbard's 1995 section 16.4 ("Productive vs. unproductive labor") and his section 16.8 ("The myth of laissez-faire") deal directly in the first instance and indirectly in the second with Smith's views on the intertemporal allocation of resources.

Rothbard assessed Smith, as he did all the major and minor figures in the history of economic thought, against the standard of Austrian economics. He found that some of Smith's predecessors, especially Cantillon and Turgot, faired better than Smith on issues involving intertemporal allocation. Rothbard's assessment may seem surprising—and surprisingly harsh—to many of today's market-oriented economists. To put this assessment in perspective, we must recognize that his assessment of modern mainstream thinking on the intertemporal issues (interest rates, saving, investment, and growth) was similarly negative and harsh. The modern mainstream is more closely akin to Smith than to the Austrians. In Rothbard's own words (1995, p. 445), "Smith wanted far more investment toward future production and less present consumption than the market was willing to choose." Mainstream pro-growth economists, even—or especially—those who fondly associate themselves with Adam Smith and his system of natural liberty, are unlikely to sympathize with criticism of this sort precisely because they have a similar intertemporal bias—a Smithian bias—in their own thinking.

I will return to the Smithian bias in the modern mainstream after offering a restatement of my own thesis and a comparison with an alternative thesis also found in recent literature.

A RESTATEMENT

Given the attention that Rothbard has called to my comment on West, I offer a restatement here by reproducing the two major sections, slightly condensed and edited to allow them to stand alone. While Buchanan focused broadly on the issues of political philosophy in his comparison of Smith and Rothbard, my comparison of Cantillon and Smith, which is based more narrowly on issues of resource allocation, lends support to Rothbard's negative assessment of Smith.

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The Economics of the Here and Later

My comparison of Cantillon and Smith entails a rather unflattering view of both thinkers. The unflattering view of Cantillon is the common one: Cantillon the Mercantilist. (Here I am simply accepting the interpretation of Professor West and many others.) Although Cantillon showed a deep understanding of a market economy and opposed state intervention of most sorts, he advocated interventions that would result in a more favorable balance of trade. Left to its own devices the market would, in general, allocate resources in a satisfactory manner. But the market would not allocate as many of the world's resources to the homeland as Cantillon preferred the homeland to have. He was not satisfied with the interspatial allocation, or more specifically the international allocation, of resources. He therefore advocated policies aimed at increasing the wealth of one nation at the expense of others.

The unflattering view of Smith is not so commonplace, but is one that, once stated and explained, should command broad acceptance (or so I believed in 1980). There is in Smith's writings an important analogue to the Mercantilists' position. Stated simply, *Smith is to time as Cantillon is to space.* In general, the market's allocation of resources was largely satisfactory to Smith. But the intertemporal allocation under a system of natural liberty was in conflict with his own vision of economic growth. The market will not allocate as many of society's resources to capital formation, and hence to future consumption, as Smith would prefer. He was therefore inclined to advocate policies (e.g., usury laws as discussed in another section of my comment and as discussed in Rothbard 1995, section 16.8) aimed at increasing the capital stock at the expense of consumption, or what amounts to the same thing, increasing future consumption at the expense of present consumption.

Smith saw his intertemporal bias as "entirely different" from the interspatial bias of the Mercantilists, but his economics of time is closely analogous to their economics of space. This is nowhere more clear than in Smith's own comparison. After explaining the unreasonableness of international restraints aimed at making the balance of trade more favorable, Smith (1937, p. 464) argued that

> There is another balance . . . very different from the balance of trade, and which, according as it happens to be either favorable or unfavorable, necessarily occasions the prosperity or decay of every nation. This is the balance of annual produce and consumption. If the exchangeable value of annual produce . . . exceeds that of the annual consumption, the capital of the society must annually increase in proportion to this excess.

Although Smith maintained that "This balance of produce and consumption is entirely different from . . . the balance of trade," the difference is one that derives straightforwardly from the difference between time and space. From the standpoint of economic efficiency the two balances can be treated the same: Under the system of natural liberty there will be a natural balance in the allocation of resources between one nation and another as well as between one period of time and another. From the standpoint of policy they *were* treated the same: Smith advocated a favorable balance of produce and consumption in the same sense that Cantillon and the other Mercantilists advocated a favorable balance of trade.

This relationship between Cantillon and Smith appears in West's paper in a slightly disguised form. West compares the "zero-sum game" of the Mercantilists

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with the "dynamic system" of Smith. While the connotation of these terms make Smith's vision look the more appealing, the terms themselves are based on the relationship just outlined. Cantillon was concerned with the allocation of resources among nations during a given period of time; Smith was concerned with the allocation of resources among periods of time for a given nation. West (1985, p. 30) imputes the dynamics of Smith's vision to the constant improvement in technology brought about by the division of labor. But Smith's vision involved something more: He wanted the system to be a little more dynamic than natural liberty, by itself, would allow. He evaluated the market against a standard that was more future oriented than the market itself, and he prescribed policy accordingly.

Productive and Unproductive Labor—Once Again

The contrast between productive and unproductive labor figures importantly into the comparison of Cantillon and Smith. The distinction between the two uses of labor is significant as a manifestation (probably the most pronounced manifestation) of Smith's bias against the present and in favor of the future. Much has been written about this curious contrast that dominates the third chapter of Book II of the *Wealth of Nations*. Undoubtedly, the controversy is at least partly attributable to Smith's own choice of words. The word "useful" appears early in the book as a synonym for "productive"; later on, the same word is used to characterize both productive and unproductive labor. (Editor Edwin Cannan points out this ambiguity in a footnote: Smith 1937, p. 315.)

It is common in classroom presentations to claim that Smith's distinction between the two kinds of labor is often misinterpreted. Presumably the misinterpretation consists of taking "unproductive" to mean "useless," and of viewing unproductive laborers as wards of society. In this view, unproductive laborers would be dependent on productive laborers in the same way that welfare recipients are dependent on income earners and—worse yet—in the same way that non-agriculture classes are dependent, in the Physiocratic view, on agriculture. The now-dominant interpretation entails a purely stipulative distinction. Productive labor produces capital goods: unproductive labor produces services. Remaining dissatisfaction with this reading hinges on the fact that it does not readily accommodate the categories of durable consumer goods or human capital.

More relevant in the context of Smith's intertemporal bias is the seemingly incongruous use of antonyms to contrast services with capital goods. In what sense are they opposites? Smith's distinction between productive and unproductive labor is to be linked not to his journey to France, as some have believed, but to his upbringing in Scotland. The basis for the distinction is not Physiocratic fallacies but Presbyterian values. Productive labor is future oriented; unproductive labor is present oriented. The former is good (or, at least, undervalued by the market) and the latter is bad (or, at least, overvalued by the market). This is the sense in which the two categories are opposites. Smith's value bias is clearly acknowledged by West (1969, p. 173) in an earlier exposition: "Smith, like a prudent steward of a Scottish aristocrat's estate, could hardly disguise a strong *personal preference* for much private frugality, and therefore for 'productive labor,' in the interest of the nation's future accumulation" (emphasis added). West quotes from the *Theory of*

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Moral Sentiments (1969, p. 311) to show that Smith's standard of intertemporal values is exhibited by his "impartial spectator." In modern parlance we would say that the impartial spectator has a zero rate of time preference.

> The spectator does not feel the solicitations of our present appetites. To him the pleasure which we are to enjoy a week hence, or a year hence, is just as interesting as that which we are to enjoy this moment.

The quotation can be extended to show the impartial spectator's view of mere mortals, who have positive rates of time preference.

> When for the sake of the present, therefore, we sacrifice the future, our conduct appears to him [the impartial spectator] absurd and extravagant in the highest degree, and he cannot enter into the principles which influence it.

It is also quite clear (from Smith 1969, p. 312) that in the absence of policy prescription based on the values of the impartial spectator, individuals would fall far short of Smith's standard.

> The pleasure which we are to enjoy ten years hence interests us so little in comparison with that which we may enjoy today; the passion which the first excites is naturally so weak in comparison with that violent emotion which the second is apt to give occasion to, that the one could never be any balance to the other.

It is not difficult to see how Smith's standard of zero time preference, coupled with his awareness of the sharply positive time preferences that govern actual market activity, could lead him to make the very policy recommendations that West found to be surprising. Smith sought to correct this natural imbalance by policies aimed at creating a favorable balance of production and consumption. He sought to reallocate resources away from the present and toward the future, that is, away from the employment of unproductive labor and toward the employment of productive labor. His proposed usury laws were designed to do just that.

IMPOSING HIS OWN VALUES OR CORRECTING FOR MARKET FAILURE?

On the occasion of the 200th anniversary of Smith's death, West (1990) reports on my analogy between Smith and the Mercantilists and my charge of a value-based intertemporal bias in Smith's writings. He offers as an alternative account of Smith's pro-growth stance the idea that capital formation involves technological spillovers, or externalities—or that it has a public-goods character to it. Here West is drawing from Jadlow (1977) and Buchanan (1976). Jadlow (as quoted by West 1990, p. 78) argues that Smith "supported interferences with the 'natural liberties' of individuals when significant technological spillovers were involved." The interference here consisted of outlawing high-interest consumption loans (and risky business loans) so that savings would be channeled towards secure, externality-producing capital formation. Buchanan, according to West, gives some credence to the idea that there are likely to be infra-marginal external economies to capital formation but wonders out loud about the policy implications. Why would Smith have advocated interest-rate ceilings rather than some more direct subsidy to capital formation?

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"In so far as these external economies arguments are persuasive," West (p. 78) writes, "they offer one answer for . . . Garrison." West's particular wording here suggests that he himself may not find this application of modern externality theory and public-goods theory wholly persuasive. After reporting on "an important remaining problem" identified by Jadlow (the problem of black markets in high-risk loans), West (p. 81) identifies two more problems with Smith's policy recommendations: (1) The information requirement would be overwhelming: In order to exploit the externalities on a project-by-project basis, the government would have to have knowledge—independent of the market itself—of the true social rate of return. Here, West's argument echoes the Austrian insights into the difficulties of economic calculation in a socialist economy. (2) Prescribing the particular intervention and enforcing it would require much more public spiritedness than Smith normally attributed to government. (But see Stigler [1971, p. 272], who, as pointed out by Jadlow [1977, p. 1198f.], "has compared Smith's attitude toward political behavior as that of a 'parent toward a child: the child was often mistaken and sometimes perverse, but normally it would improve in conduct if properly instructed.'")

To West's even-handed but skeptical treatment of the external-economies argument, I can add, if only marginally, to the reasons for dismissing it. If we think macroeconomically, we see that the existence of externalities to capital formation does not, by itself, have clear policy implications. We cannot simply claim that a high growth rate is good and that a higher growth rate is better. Even benevolent, public-spirited policymakers would find themselves faced with a dilemma: They could maintain a policy of laissez-faire and forego the social gains that exploiting the externality would entail, or they could intervene and risk overcorrecting for the perceived market failure, which may well entail a net social loss. The market operating in a system of natural liberty may produce a growth rate of, say, 2 percent. Forced growth of 2.5 percent may entail a higher social rate of return; forced growth of 3 percent may entail the same social rate of return as natural growth of 2 percent; and forced growth of 3.5 percent may entail a social rate of return that is actually less than would have been enjoyed with the economy growing at its natural rate. If we had the effect of forced growth on social well-being expressed mathematically, we could take a derivative and set it equal to zero. But we cannot know if a particular pro-growth policy will leave us short of the hump or put us at the hump, beyond the hump, or even beyond the horizontal intercept of this growth-effect function. This and all other instances of alleged market failure are also instances in which the policymaker is operating in the dark. The systematic occurrence of the "need for interventionist policy" together with the lack of information on which to base a particular policy prescription is what I have elsewhere called Vaughn's conundrum (Garrison 1992).

The knowledge problem identified here may be seen as a macroeconomic perspective on the information problem pointed out by West. However, to state the problem in such twentieth-century terms is to make it obvious that this is not how Smith saw the problem. In fact, even to believe that Smith based his policy recommendations primarily on an external-economies argument or on a public-goods argument requires, in my judgment, a hefty dose of hindsight and a creative reading of the *Wealth of Nations*. At best, hints of public-goods qualities and external

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economies, such as were cited by Buchanan and Jadlow, are used by Smith to help rationalize a value-based policy prescription that runs counter to his general defense of the system of natural liberty.

Linking Smith's understanding of the system of natural liberty to his ethical ideas in the *Theory of Moral Sentiments* and with specific reference to the "impartial spectator," Robert Prasch (1991, p. 348) inverts the conventional interpretation of Smith, turning cause into effect and effect into cause: "The process of capital accumulation is thus at heart a process which compels the rationalization of the 'rustic' world which precedes it." This idea comes from Smith's book 3, chapter 4, "How the Commerce of the Towns contributed to the Improvement of the Country." In Smith's own words (1937, p. 385), as quoted by Prasch (1991, p. 348):

> commerce and manufactures gradually introduced order and good government, and with them, the liberty and security of individuals, among the inhabitants of the country, who had before lived in a continual state of war with their neighbors, and of servile dependency upon their superiors. This, though it has been the least observed, is by far the most important of all their *effects*. [emphasis added]

Commerce fosters liberty. Or is it the other way around? The evidence provided by Prasch, coupled with the more conventional understanding, suggests that we might have to take Smith as simply believing that liberty and commerce (including capital accumulation) go together and of being in favor of both.

The prominence of the far-sighted impartial spectator in Smith's thinking warns against undue reliance on any notions of the supposed synergistic effects of commerce and liberty or on the positive externalities or the public-goods character of capital accumulation in understanding Smith's intertemporal bias. His bias, at root, is simply a reflection of his values. If this judgment is in need of some qualification, it is only because of the fact, reported by Rothbard (1995, p. 436), that Smith's *Wealth of Nations* lacks the lucidity and clarity that is so often imputed to it.

INTERTEMPORAL BIAS IN MODERN ECONOMIC THOUGHT

In my original comment, I summarized my thesis and brought the issues forward to modern times: Smith succeeded in ridding economic theory of the interspatial bias associated with Cantillon and other Mercantilists and then proceeded to introduce a strong intertemporal bias of his own. From the vantage point of the twentieth century, it can be said that while the battle against the interspatial bias has long since been won—due largely to the efforts of Adam Smith—the battle against the intertemporal bias is still being fought.

Evidence of the bias can be seen in professional papers as well as in textbooks at all levels. Although specific pieces of evidence abound in the literature, I focus on a passage from Milton Friedman, who may well be Buchanan's "modern analogue to Adam Smith," and one from Gregory Mankiw, whose new principles-level textbook is quickly winning him the reputation as the next Samuelson.

The *Modern Guide to Macroeconomics* (Snowden, Vane, and Wynarczyk 1995) gives play to the multiplicity of schools of thought by presenting macroeconomics in a school-per-chapter format. In their introductory chapter, the authors try

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to avoid giving the false impression that macroeconomics is nothing but a "battlefield, with regiments of economists grouped under different banners " (p. 3). They claim that "economists tend to disagree more over theoretical issues, empirical evidence and the choice of policy instruments than they do over the ultimate objectives of policy." In order to drive home the idea that in this one area (ultimate objectives of policy) there is a virtual unanimity of opinion, they quote Milton Friedman (1968) to this effect: "There is wide agreement about the major goals of economic policy: high employment, stable prices, and rapid growth." I suspect that most readers of the *Modern Guide* or of Friedman's seminal article would read right through this statement in search of some more substantive proposition. That is, these goals do command such broad assent that the statement is little more than a throat-clearing introduction to some other issues more worthy of our attention.

While Rothbard and most Austrian economists would have critical remarks to make about each of the three goals announced by Friedman, my immediate concern is with the third goal: rapid growth. Had Richard Cantillon or François Quesnay, rather than Adam Smith, achieved the status of the Father of Economics, Friedman may well have announced the third goal as a favorable balance of trade or as a prosperous agriculture sector. To modern mainstream economists, these mercantilist and physiocratic goals seem misconceived or, at best, redundant. We would certainly want the quantity and price of imports and exports to be consistent with supply and demand conditions for these internationally traded goods—and similarly for the quantity and price of agricultural products. But these balances are not policy goals; they are a result of the market itself. Similarly, we are entitled to wonder why Friedman's third goal should not seem equally misconceived or, at best, redundant. A rapid growth rate simply means a high ratio of future output to current output. The more we sacrifice today, the more we can consume tomorrow. We certainly want this sacrifice and the corresponding growth rate to reflect the intertemporal consumption preferences of market participants. But this is not a policy goal; it is a result of the market itself. In comparing Friedman and Smith, it is significant that Friedman considers the goal of rapid growth to be an ultimate one in some sense. He does not argue that the goal is an implication of some theory of externalities or theory of public-goods as applied to capital formation. Those theories shed no more light on Friedman's views than on Smith's. While Smith relied on the impartial spectator and the other-worldly perspective that this construction entails, Friedman relies on the broad consensus among economists. Though no Presbyterian, Friedman does exhibit a Smithian bias—an underlying value bias—by embracing rapid growth as an ultimate policy goal.

Another aspect of the modern intertemporal, or pro-growth, bias is found most commonly in principles-level texts, in the curious treatment of compounding. It is true that small differences in saving rates and hence growth rates can, over a span of many years, translate into large differences in standards of living. Yet the so-called "magic of compounding" provides no basis for a rapid-growth policy. The role of the economist here should be one of dispelling the illusion of magic rather than one of transforming the perceived magic into a special defense of rapid economic growth as a policy goal. Writing for college sophomores, Gregory Mankiw (1997) chooses to perpetuate rather than dispel the illusion of magic. His chapter on

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production and growth includes an "FYI Box" titled "The Magic of compounding and the Rule of 70" (p. 240). Why should we care, he asks, whether the economy grows at 1 percent or at 3 percent? The difference in the two growth rates, i.e., 2 percent, *seems* small. But over a period of forty years, income in the high-growth economy will be more than twice the income in the low-growth economy. Voilà! It's magic! And only forty years!

But, wherein lies the magic? Is it in the economics? Or is it in the mathematics? It is ironic, I think, that Rothbard and the Austrians, who tend not to present their economics in mathematical dress, would see no magic in compounding, while those who would readily write $y_t = y_0(1+g)^t$ somehow see this exponential function as entailing magic. Surely, the economist should assess the two growth rates in accordance with the intertemporal preferences of the market participants. Whichever one, if either, is consistent with those preferences is the one that should prevail and that—absent persuasive arguments to the contrary—will prevail in a system of natural liberty.

In a subsection titled "Economic Growth and Public Policy," Mankiw seems to shift without warning from an unbiased view of the intertemporal trade-off to a policy view that is colored by a Smithian bias. First, he anchors his ideas in basic economic principles:

> Because resources are scarce, devoting more resources to producing capital requires devoting fewer resources to producing goods and services for current consumption. That is, for society to invest more in capital, it must consume less and save more of its current income. The growth that arises from capital formation is not a free lunch: it requires that society sacrifice consumption of goods and services in the present in order to enjoy higher consumption in the future. (p. 247)

This statement of the economic relationship between present and future consumption would no doubt have been gleefully embraced by Rothbard. The market process that governs the trade-off between consuming now and consuming later is on a par with the market process that copes with other aspects of scarcity. In his very next paragraph, however, Mankiw notes that "encouraging saving and investment is one way that a government can encourage growth and, in the long run, raise the economy's standard of living." But, on what grounds would the government "encourage" people to make the intertemporal trade-off differently from how they would make it without the encouragement? Mankiw does not mention externalities or public goods. And he tends not to be paternalistic generally in his policy prescriptions. Is there some informational asymmetry whereby policymakers are more attuned to the "magic of compounding" than are market participants? No such argument is offered. More plausibly, the alleged magic simply serves as a rhetorical device for introducing an intertemporal bias that has its roots in Adam Smith.

From Smith's day to our own, economists have tended to treat the intertemporal trade-off as something quite different from other trade-offs that market participants face. Whether based on the impartial spectator or on a perceived consensus among economists or on a supposed magic of compounding, their thinking is biased in favor of the future. They write as if they believe that the prospect of a more-than-doubled real income forty years hence should have a greater effect on our current

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willingness to save than it actually has. On this idea, whether offered by Smith himself or the modern mainstream, Rothbard has expressed dissent.

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MURRAY ROTHBARD CONFRONTS ADAM SMITH

PAUL B. TRESCOTT

A noteworthy feature of Murray Rothbard's monumental history of economic thought is his vigorous denunciation of Adam Smith and the *Wealth of Nations*. Smith was "an inveterate plagiarist," but one who "plagiarized badly, adding new fallacies to the truths he lifted." Smith's "economics was a grave deterioration from his predecessors, from Cantillon, from Turgot, from his teacher Hutcheson, from the Spanish scholastics, even . . . from his own previous works" (Rothbard, pp. 435–36). Smith's book distracted people away from these meritorious earlier works. The "*Wealth of Nations* is a huge, sprawling, inchoate, confused tome, rife with vagueness, ambiguity and deep inner contradictions" (Rothbard, p. 436).

In the following, we will review Rothbard's principal criticisms and add some that he overlooked. However, he has failed to take note of some of the positive virtues of *The Wealth of Nations*. We will also refer to relevant aspects of the works of Cantillon and Turgot, whom Rothbard praised highly.

Rothbard's commentary follows the sequence of *The Wealth of Nations*, and we will do the same.

DIVISION OF LABOR

"It is appropriate to begin . . . with the division of labor, since Smith himself begins there" (Rothbard, p. 441). Not quite. Smith's initial point is that the wealth of the nation is its output of goods and services, and division of labor is analyzed as a major contributor to national productivity (Smith, p. lvii). In Rothbard's view, "for Smith the division of labor took on swollen and gigantic importance" (Rothbard, p. 441). In Smith's Book 1, "division of labor alone accounts for the affluence of civilized society" (Rothbard, p. 442). However, Smith soon makes it clear that division of labor depends critically on capital, and that capital is the engine of growth. In Smith's eyes, division of labor creates the basic problems of information and motivation, which in turn require an explanation of how a market economy works to guide economic activity. Smith also expects growth of capital to generate technological progress (Smith, p. 260). But Rothbard is entirely correct in noting that Smith was totally

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oblivious to the technological changes going on around him.[1] We might particularly have expected him to be aware of James Watt and the steam engine.

Rothbard claims that Smith "failed to apply his analysis of the division of labor to international trade" (Rothbard, p. 442). But international exchange is present in Smith's very first sentence, where he notes that economic well-being arises from "the immediate produce of labor . . . or . . . what is purchased with that produce from other nations" (Smith, p. lvii). It enters Smith's panegyric on "the accommodation of the most common artificer or day-laborer in a civilized and thriving country," which involves, among many other things, recognizing

> how much commerce and navigation in particular, how many ship-builders, sailors, sail-makers, rope-makers, must have been employed in order to bring together the different drugs made use of by the dyer, which often come from the remotest corners of the world. (Smith, p. 11)

And division of labor figures prominently in Smith's defense of free international trade.[2]

Rothbard also contends that Smith neglected "the more significant division of labor among industries" (Rothbard, p. 442). However, numerous industries and occupations are cited in introducing the topic (Smith, pp. 11–12, also, 14, 17–18, 86).

Moreover, Smith highlights the role of the market mechanism in directing people into occupations:

> If in the same neighborhood, there was any employment evidently either more or less advantageous than the rest, so many people would crowd into it in the one case, and so many would desert in the other, that its advantages would soon return to the level of other employments. (Smith, p. 99)

PRODUCTIVE AND UNPRODUCTIVE LABOR

Rothbard has an easy time showing the semantic defects of Smith's analysis of productive and unproductive labor.[3] When the topic is fully developed, in chapter 3 of book 2, the context has been clearly set forth—it is the accumulation of physical capital. Smith makes it clear that "unproductive" labor can have both public and private value.[4] I find no support for Rothbard's claim (undocumented) that "Smith . . .

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[1] Equally true, though perhaps more defensible, for Cantillon and Turgot.

[2] International division of labor is particularly celebrated in Smith's assessment of the impact of the discovery of America: "By opening a new and inexhaustible market to all the commodities of Europe, it gave occasion to new divisions of labor and improvements of art, which in the narrow circle of the ancient commerce, could never have taken place" (Smith, p. 416; see also pp. 424, 590).

[3] Somehow Rothbard glossed over (Rothbard, p. 393) Turgot's similar but even less fruitful claim that only agricultural workers were productive.

[4] Speaking of "menial servants," Smith remarks "The labor of the latter, however, has its value and deserves its reward" (p. 314). Speaking of government employees, he notes, "Their service, how[ever] honourable, how[ever] useful, or how[ever] necessary. . . produces nothing for which an equal quantity of service can afterwards be procured" (p. 315). See also his favorable remarks on people who "amuse and divert the people by painting, poetry, music, dancing; by all sorts of dramatic representations and exhibitions" (p. 748).

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excludes all production of immaterial services from the annual product" (Rothbard, p. 445; contrary evidence appears at p. 448, quoting Smith, p. 30). What Smith does say over and over is that *increase* in the national product results primarily from saving, investment, and productive labor (Smith, pp. 320–23, 464, 574, 577, 640–41). The harm done by mercantilism results partly from reduction of investment and misallocation of what remains (Smith, pp. 325, 562, 570–73, 594–95, 637–38).

Rothbard documents more persuasively his view that Smith had a "Calvinistic scorn of consumption" (Rothbard, p. 447), but this can be tempered by passages in *The Wealth of Nations* (pp. 325–29, 459, 569, 726–27, and 748.)[5]

Rothbard's claim that Smith "was not content to abide by free-market choices between growth . . . and consumption" would be difficult to prove and diverts our attention from Smith's emphasis on the harmful deviations from free-market outcomes arising from government.[6] Rothbard accuses Smith of a bias against durable consumer goods, but this seems clearly contradicted by *The Wealth of Nations* (pp. 329–32).

Ultimately, of course, Rothbard is criticizing Smith because his distinction between productive and unproductive labor, and his materialistic analysis of development, easily led to the perversions developed by Marx. From these origins can be traced the Stalinist neglect of services and the helter-skelter pursuit of growth through forced investment undertaken with little regard to cost or allocation.

THE THEORY OF VALUE

According to Rothbard, "Smith's doctrine on value was an unmitigated disaster" (p. 448). In particular, *The Wealth of Nations* was inferior to Smith's earlier expositions in his lectures. In *The Wealth of Nations* value in use is distinguished from value in exchange; whereas, in the lectures, Smith had easily explained the diamond-water paradox by reference to relative scarcity.

> And with scarcity gone . . . , subjective utility virtually drops out of economics as well as does consumption and consumer demand. Utility can no longer explain value and price, and the two sundered concepts will reappear in later generations as left-wingers and socialists happily prate about the crucial difference between "production for profit" and "production for use." (Rothbard, p. 449)

As if this were not bad enough, Smith "was almost solely responsible for the injection into economics of the labor theory of value" (Rothbard, p. 453)—that is, the argument that products exchange in proportion to the labor (direct and indirect) embodied in each.[7] Rothbard exaggerates the degree to which Smith viewed labor

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[5]Rothbard does not comment on the fervent denunciations of "luxury" that appear in Cantillon (pp. 193–99).

[6]"It is the highest impertinence and presumption . . . in kings and ministers, to pretend to watch over the economy of private people, and to restrain their expense, either by sumptuary laws, or by prohibiting the importation of foreign luxuries. . . . If their own extravagance does not ruin the state, that of their subjects never will" (Smith, p. 329).

[7]Although Cantillon did not advance a labor theory of value as such, he was clearly on the same track, basing "intrinsic value" on "the quantity of land and labor entering into the production" (Cantillon, p. 29). Note this was a theory based on input quantities, not values or costs (see Brems 1978).

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input as the *determinant* of value. Most secondary treatments more plausibly note that Smith tried (not very successfully) to use labor command as a *measure* of value. But it is still broadly true that Smith set the stage for Ricardo and Marx by passages which presuppose that labor is the source of all value, and that property incomes are somehow diversions which may be morally and functionally dubious. While Smith does indicate why payments for the use of physical or money capital are appropriate, he never indicates that landowners perform any useful activity that would warrant their rent incomes.

Rothbard clearly acknowledges that Smith's primary theory is that products tend, in the long run to exchange at values equal to the factor costs (direct and indirect) of each, where those factor costs reflect the "normal" values for services of land, labor, and capital.[8] Although this is now (with appropriate elaborations) standard doctrine in undergraduate textbooks, Rothbard does not think highly of it: "Value and price theory shifts, because of Adam Smith's unfortunate and drastic change of focus . . . , from prices in the real world to a mystical non-existent price in the never-never land of long-run 'equilibrium'" (Rothbard, p. 450).

Rothbard acknowledges that "The long-run normal price is important but only for explaining the directional tendencies and the underlying architectonic structure of this economy" (Rothbard, pp. 450–51).

"But only" indeed! Smith's theory of value is in reality his vision of the determination of the composition of output and the allocation of resources in a self-correcting market economy. This general-equilibrium point of view is effectively developed in many sections of *The Wealth of Nations*.[9]

Both Cantillon and Turgot had earlier presented theories of long-run normal price. Cantillon's referred to "intrinsic value" of a product, which is "the measure of the quantity of land and of labor entering into its production." But he devoted a lot of attention to the determination of market prices by supply and demand.[10] Turgot argued that the "fundamental value" of a product was its unit cost (specifically allotted to wages, profits, and raw materials) (Groenewegen, p. 181).

Smith repeatedly stresses the adjustment process underlying resource allocation. Moreover, although subjective utility is indeed neglected, the pattern of

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[8]By implication, Rothbard criticizes Smith's theory because it cannot account for the values of items "which have no cost because they are not produced" (Rothbard, p. 452). Smith does briefly look at the pricing of items "which it is scarce in the power of human industry to multiply at all," and clearly identifies demand as the determinant (Smith, p. 218).

Hollander (1973) notes that important parts of Smith's theory of value are presented later in the book (Smith, pp. 217–47) mainly in a context of economic growth. Here appear clear precursors of historical increasing returns or decreasing returns.

[9]The point is strongly stated in Hollander (1973) and amplified in Trescott (1997).

[10]Rothbard's discussion of Cantillon, while somewhat lopsided, at least acknowledges both elements (Rothbard, pp. 349–51). Murphy asserts that Cantillon "considered intrinsic value to comprise the costs of the factors of production plus normal profit" (Murphy, p. 252). Aspromourgos has a similar view (pp. 81, 95). However, this is never clearly developed in the *Essai* (see Cantillon, pp. 29–31). It appears Cantillon intended his intrinsic-cost analysis to be a guide to mercantilistic regulations (see *Essai*, p. 233).

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resource allocation is demand-driven: "The quantity of every commodity brought to market naturally suits itself to the effectual demand" (Smith, p. 57).[11]

Rothbard grudgingly acknowledges these passages (Rothbard, p. 451), but maintains that "only the market price is the real price" (Rothbard, p. 450). His judgment is clouded by his fixation on *price* determination, whereas Smith's real concern is with *quantities.*

Smith returns the reader to this general-equilibrium perspective at many points. He reiterated the tendency for the price of any factor of production to become equalized in its various uses as each resource owner shops around for the most advantageous employment.[12] This is the point of departure for the famous chapter 10 of book 1, which examines "equalizing differences" in reward which tend to persist (Smith, pp. 99–143). Here also Smith uses his general-equilibrium approach as a basis for denouncing the "policy of Europe," by which rent-seeking behavior leads to interventions that create unfair monopoly rents and misallocate resources (Smith, pp. 118 ff.). This criticism resumes, with emphasis on the misallocation of capital among sectors, in chapter 5 of book 2 (see esp. pp. 352–53) and the little-read book 3. Profit-seeking in a free market will lead each individual to employ his capital "in the support of that industry of which the produce is likely to be of the greatest value, or to exchange for the greatest quantity either of money or of other goods" (Smith, p. 423). A sophisticated perception of demand underlies Smith's brilliant "Digression Concerning the Corn Trade and Corn Laws," where he explains the rationing function of high prices during a period of shortage, with particular attention to spreading out consumption over time (Smith, pp. 491–510).

THE THEORY OF DISTRIBUTION

The pricing of the factors of production is critical to the pricing of products. Rothbard believes that "Smith's theory of distribution was fully as disastrous as his theory of value" (Rothbard, p. 458). Here much of Rothbard's criticism is well warranted.[13] Smith indeed had no adequate theory of the rate of return on capital (though he talked sensibly, if not very originally, about the close link between that rate of return and the market interest rate). His analysis of rent is muddled.

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[11]The general notion of a demand-driven general equilibrium recurs with regard to labor (Smith, p. 80) and precious metals (Smith, pp. 403–6). Rothbard might appropriately reply that the optimality of a demand-driven allocation can only be established with explicit reference to subjective utility, as in discussions of Pareto optimality. However, much of the "production for use instead of for profit" literature came from people like Veblen, who were thoroughly familiar with, but disdained, the role of subjective value. Cantillon does not indicate that free-market outcomes are optimal (see Cantillon, pp. 87–93).

[12]There are hints of a general-equilibrium perspective in both Cantillon and Turgot (see Aspromourgos 1996, p. 156). But the principles are evident to a modern reader who already understands the concept; eighteenth-century readers would hardly have learned them from these remarks.

[13]Cantillon's analysis of factor prices is even less impressive. Aspromourgos (1996) attributes to him the assumption of an exogenous real wage (p. 82). Cantillon has numerous passages involving labor-market disequilibrium, but these never entail equilibrating movements of wages (see pp. 61–65, 73, 87, 91–93).

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However, Rothbard misrepresents both the content and merit of Smith's wage theory.[14] Smith reminds the reader at many points that the basis of wages is the productivity of labor.[15] Chapter 8, book 1, "Of the Wages of Labor," begins with the blunt assertion that "The produce of labor constitutes the natural recompense or wages of labor" (Smith, p. 64). We are briefly informed that labor productivity depends in part on human capital (pp. 265–66, 641), but Smith mainly emphasizes the role of growth of capital in raising demand for labor. Increase in the capital stock raises labor productivity, and there are also hints of a primitive kind of Keynesian macroeconomic multiplier (esp. Smith, pp. 69–74).

Wages also depend on the supply of labor, reflecting the size of the population. Wages cannot remain below subsistence, since labor supply will be impaired. On the other hand, high wages will reduce death rates and thus spur population growth. Rothbard attributes to Smith the view that "wages tend to settle at the minimum subsistence level for the existing population" (Rothbard, p. 458). This is a serious misrepresentation, losing as it does the entire thrust of Smith's optimistic view concerning economic growth (below). Smith demonstrated that wages in Britain were well above the biological subsistence level (Smith, pp. 74–81). To be sure, high wages encourage population growth. But this is no bad thing. Smith had a far more sensible view of these matters than had Malthus and Ricardo. Labor supply adjusts very slowly, so the (minimum) subsistence wage will come about only in countries where "wealth . . . has been long stationary," where "long" means "several centuries" (Smith, p. 71; also pp. 94–95). And food output should have no difficulty in keeping pace with population (p. 187).

Smith's chapter on colonies brilliantly sketches the manner in which abundance of land in newly settled areas affects relative wages (high), land values (low), and social relationships (egalitarian) (Smith, pp. 532–33, 551–53).

THE THEORY OF MONEY

Rothbard is on sound ground in finding Smith's discussions of money very defective. In particular, Smith failed to transmit the essence of Cantillon's and Hume's specie-flow models of price-level and international-trade adjustment, although his lectures show he was familiar with these.

Part of Rothbard's criticism of Smith stems from Rothbard's antipathy toward fractional reserve banking, reflecting the Hayek–Mises theory of business cycles. In truth, fractional reserve banking is one more example of a spontaneous social development that has enhanced economic productivity by creating a more efficient system of payments and credit.

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[14] An especially outrageous assertion is that "Richard Cantillon's theory of wages is dependent on population in a way that was copied almost word for word by Adam Smith" (Rothbard, p. 352). While Cantillon's discussion of population is impressive (Rothbard, pp. 352–53) the link with wages is quite unclear. At most, Cantillon simply asserts that wages tend to subsistence, where the latter term is clearly conventional and customary rather than biological (pp. 31–41). Smith acknowledged Cantillon's argument that wages could not be below the subsistence level. Beyond that, Smith's discussion has no counterpart in Cantillon. In particular, Smith's analysis linking capital, growth, and wages appears quite original.

[15] This is clear in the discussion of professional incomes at p. 717.

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RISK AND ENTREPRENEURSHIP

Rothbard is appropriately critical of Smith's neglect of the special qualities of entrepreneurship. Cantillon had dealt with this at length, stressing the nature of market risks and the importance of "undertakers" operating in a world of uncertain information.[16] Smith simply credits progress and prosperity to the "effort of every man to better his condition" (p. 326; see also pp. 594–95). When merchants and manufacturers come in for separate discussion, it is usually a criticism of their political role (Smith, pp. 128, 249–50, 429, 438, 460).

SMITH AND LAISSEZ-FAIRE

Rothbard finds that "in *The Wealth of Nations* . . . *laissez-faire* becomes only a qualified presumption rather than a hard-and-fast rule, and the natural order becomes imperfect and to be followed only 'in most cases'" (Rothbard, p. 465). Rothbard criticizes Smith's concessions regarding national defense, education, and usury laws.[17] Further, Smith's twelve-year career as customs commissioner does not reveal him as a practical champion of free trade.[18]

There is here a sense that Rothbard is displeased because Smith has denounced only 90 percent of harmful government interventions rather than 100 percent.[19] Let us remember that it is the virtues of free markets and limited government that receive the emphasis in the beginning sections of *The Wealth of Nations*—the sections of a nine-hundred-page work most likely to influence readers. Remember, too, the double-barrelled nature of Smith's argument. One element is that the system of "perfect liberty" leads to good economic and social outcomes.[20] The

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[16]However, Aspromourgos argues that Cantillon's vision of entrepreneurship is "pre-capitalist" and gives no real analysis of profit as a distributive share nor of capitalists as a social class (pp. 82, 121). Smith occasionally salutes creative entrepreneurship (see pp. 115, 384–85, 491–510). But contrast his negative view of "prodigals and projectors" (pp. 339–40).

[17]Rothbard's list of Smith's exceptions to laissez-faire (Rothbard, p. 466) could be even longer. In addition to favoring government suppression of small bank notes, Smith also approved the Dutch practices of requiring commercial settlements in banknotes and relying on municipal guarantee of bank reserves (Smith, pp. 447–48, 453–55). He approved of "premiums given . . . to artists and manufacturers who excel in their particular occupations" (p. 489). He was willing to countenance temporary grants of monopoly to joint stock companies in "remote and barbarous" areas, as well as similar monopoly privilege to inventors and authors (p. 712).

[18]In contrast, "When Turgot became finance minister in France in 1774, his first act was to decree freedom of import and export of grain" (Rothbard, p. 367).

[19]It is especially illuminating to compare Rothbard's treatment of Cantillon, whose *Essai* is shot full of the crudest kind of mercantilist fallacies, including bullionism. Rothbard claims that "the entire thrust of Cantillon's work was in a free trade, *laissez-faire* direction" (Rothbard, p. 359). Quite the contrary. Cantillon clearly felt that his real-cost analysis provided guidance for state controls of trade to gain maximum advantage over foreigners. He states that

> It is by examining the results of each branch of commerce singularly that foreign trade can be usefully regulated. It cannot be distinctly apprehended by abstract reasons. It will always be found . . . that the exportation of *all* manufactured articles is advantageous to the state . . . [and] that the best returns or payments imported are specie. (p. 233)

[20]Smith states that

> Without any intervention of law . . . the private interests and passions of men naturally lead them to divide and distribute the stock of every society, among all the different employments

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other is an oft-repeated analysis of "government failure." Paranoid nationalism, national rivalries and oppression of colonial domains are part of this failure.[21] Stylistically, some of Smith's finest rhetoric is employed in exercising this double-barrelled weapon.[22]

According to Rothbard, Smith's "devotion to the militarism of the nation-state . . . induced him to take the lead[!] in the pernicious modern view of excusing any government intervention that might plausibly be labelled for 'the national defense'" (Rothbard, p. 465). Smith referred to "the art of war" as "certainly the noblest of all arts" (Smith, p. 658). He argued that "It is only by means of a standing army . . . that the civilization of any country can be perpetuated, or even preserved for any considerable time" against invasions from the Tartars or other barbarous hordes (p. 667).

However, Smith was hardly a militarist. He saw that military force was essential for the protection of trade and commerce, a lesson which Thomas Jefferson was soon to learn the hard way. Britain had no conscript military and relied primarily on a volunteer navy for its defense. Smith's support of "martial spirit" should be seen as an implicit defense of a volunteer military service (Smith, pp. 735, 738–39). Smith's concession that "defense . . . is of much more importance than opulence" (p. 431) concluded a two-page discussion of the navigation acts (aimed at supporting that volunteer navy), in which Smith noted their economic disadvantages. Those disadvantages were the principal thrust of his subsequent discussion of the navigation acts in the context of colonial policy (Smith, esp. pp. 562–65).[23]

According to Smith, government has a duty "of erecting and maintaining those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature, that the profit could never repay the expence to any individual or small number of individuals" (Smith, p. 681). These would include projects to facilitate commerce: "good roads,

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carried on in it, as nearly as possible in the proportion which is most agreeable to the interest of the whole society. (pp. 594–95. See also pp. 353, 424–25, 456, 466, 471, 473, 483, 489, 497, 506, 529, 570, 572, 597, 637–38)

[21] "Commerce, which ought naturally to be, among nations, as among individuals, a bond of union and friendship, has become the most fertile source of discord and animosity" (Smith, p. 460; see also pp. 580–82, 590–606). In contrast, Cantillon "perceived international trade as a zero sum game in which one country could grow only at the expense of another" (Murphy, pp. 8, 279).

[22] Smith states that

> The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to use it. (p. 423; also p. 651)

Smith had a clear perception of what we now call rent-seeking behavior, and warned that interventions tend to create vested interests which block their removal (Smith, pp. 438–9, 571).

[23] Rothbard does not mention the fact that Cantillon also strongly supported the navigation acts (see Cantillon, pp. 239–43).

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bridges, navigable canals, harbours" (p. 682). But how do we know which ones are "in the highest degree advantageous?" Smith advocates relying on user charges as much as possible, recognizing that through this use of the market mechanism, "they can be made only where the commerce requires them, and consequently where it is proper to make them" (p. 683).

Smith also felt that government should supply some educational services, but again stressed the importance of user charges in motivating the teachers (pp. 716–21). Smith clearly expected that market forces would provide the society with most of the needed education. His affirmative mandate for government's role in education appears to embrace two different concerns. The first anticipates the lofty goals of liberal education as often encountered in college catalogues (Smith, pp. 734–35, 740).[24] The second involves "the most essential parts of education . . .[:] to read, write, and account." He does not directly recommend compulsory school attendance, but suggests a kind of qualifying examination before a man "can obtain the freedom in any corporation, or be allowed to set up any trade either in a village or town corporate" (Smith, pp. 738, 748).

While Smith's agenda for government actions involving commerce and education may appear extensive, his qualifications regarding user charges were strong and consistent, reflecting his concern for "incentive-compatible" outcomes (see also Smith, p. 767). In neither area does he appear to contemplate government monopoly.

Taken in its entirety, *The Wealth of Nations* enumerates a vast array of government measures that Smith disliked. Restrictions (or artificial preferences) on imports and exports are probably the chief target. Others include special privileges of guilds and corporations, systems of apprenticeship, limits on geographic and occupational mobility, wage controls, and currency debasement. Governments are condemned for condoning slavery and systems of primogeniture and entail. We are told that government employment can have morally degrading effects and that government extravagance diverts resources from saving and investment. Smith denounced government interventions in grain markets, such as price controls, discrimination against middlemen and restrictions against "engrossing." While extolling benefits from the discovery of America, Smith condemned at great length the abusive treatment of colonies. These specific references are intermixed with analytical principles that support the optimality of economic activity constrained by competition and by protection of public order, property, and contracts. On numerous occasions, the reader is reminded of the limitations and incapacities of government. Rothbard's commentaries do not communicate this quality to the reader.

AN INSPIRATION FOR MARX

Rothbard justifiably argues that Smith provided much ammunition for Marx and other socialists. Smith helped promote the labor theory of value, even if on balance he did not believe in it. His discussions of rent, interest, and profits failed to provide

[24]Rothbard notes that one of Smith's educational goals was to inculcate obedience to government (Rothbard, p. 466). Considering that Smith has just presented several hundred pages of strong criticism of many government policies, one might better interpret his remarks as a preference for peaceful and orderly methods of political action.

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a functional defense for property incomes. Smith's strictures on government anticipated many elements of the modern theory of public choice, but they also presented a rather stark social-class interest-group analysis of political action. From his erroneous notion that profit rates decline with economic growth, Smith argued that the self-interest of capitalists was thus opposed to progress. He tended to equate the functional shares of income going to land, labor, and capital, with separable social classes. Many of his references to businessmen were extremely hostile (see Ginzberg 1934). His characterization of productive and unproductive labor paved the way for the Marxian neglect of services. Marx's muddled view, which identified the flow of wage payments with "capital," bears some resemblance to Smith's early version of the wage fund theory.

The chief contrary argument would be, of course, that Smith consistently argued that the growth of capital raises real wages and operates to the benefit of the working class, which is protected by competition in the labor market. It was Malthus and Ricardo who turned economics into a dismal science by their gross exaggeration of diminishing returns and resource constraints.

INTRINSIC ADVANTAGE IN CAPITAL ALLOCATION

Surprisingly, Rothbard neglects one of Smith's most serious analytical defects. Smith's analysis of capital often holds that there are *intrinsic* advantages in using capital in some sectors rather than others. Most obvious is his contention (clearly derived from the Physiocrats) that investment in agriculture is always preferable to commerce or manufacturing.[25] He claims that

> the capital employed in agriculture . . . not only puts into motion a greater quantity of productive labor than any equal capital employed in manufactures, but in proportion too to the quantity of productive labor which it employs, it adds a much greater value to the annual produce. . . . Of all the ways in which a capital can be employed, it is by far the most advantageous to the society. (Smith, p. 345)

In a similar manner, Smith went on to differentiate between home trade, foreign trade of consumption, and carrying trade.

This mode of discourse is not a mere aside, but provides a major part of Smith's critique of mercantilism and the "policy of Europe" in books 3 and 4 (pp. 343–55, 421–23, 566–73, 593–94). To be sure, Smith's underlying argument is against deviations from the free-market allocation of capital. But the exposition is hardly felicitous.

SMITH'S ANALYSIS OF ECONOMIC GROWTH

Rothbard's assessment of Smith neglects the fact that *The Wealth of Nations* is in large measure a book about economic growth and development. As noted, Smith's wage theory is presented in the context of economic growth. Capital formation is the engine of growth, helping in turn to improve division of labor and (occasionally) to

[25]Cantillon had presented an extreme argument that most economic magnitudes "depend on" the actions of the landowners. For Turgot, only agricultural activity was "productive."

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promote technological improvement. The process is benign; it raises wages and thus benefits the common people. Higher wages will of course tend to speed up population growth, but Smith sees no real problem with this. Smith clearly recognized the phenomenon that came to be called diminishing returns, viewed in a dynamic context with reasonable technological improvement (Smith, pp. 60–61, 154–57, 175, 217, 235). But he explicitly argued that corn, the basic subsistence food, would not be subject to diminishing returns (p. 187). Thus, Smith avoided the near-paranoid concern with food shortage and resource constraint that marred the work of his successors.

Smith also found important benign aspects to the process of economic development. Smith argued that

> commerce and manufactures gradually introduced order and good government, and with them, the liberty and security of individuals, among the inhabitants of the country, who had before lived almost in a continual state of war with their neighbors, and of servile dependency upon their superiors. (Smith, pp. 384–92 at 385)

And he dwelt at length on the beneficial effects of the discovery of America in extending division of labor and introducing new products.

In contrast, neither Cantillon nor Turgot dealt with economic growth. According to Murphy (1986), "Cantillon had a static interpretation of economic processes" (pp. 8, 279). Aspromourgos (1996) concluded that

> whatever the extent of the Quesnay–Turgot influences upon Smith, his integration of distribution, value, and capital accumulation in a quite comprehensive treatment of capitalist economic development better captured the essentials of the prevailing trend of historical development than had any of his predecessors. (p. 157)

CONCLUSIONS

Rothbard's forty-page chapter on Smith focuses on the latter's deficiencies so much so that there is no pretense of giving a systematic overview of *The Wealth of Nations*. Rothbard cites Schumpeter as one of the first to mount an authoritative deflation of Smith's exaggerated reputation. But Schumpeter also said that *The Wealth of Nations* "is a great performance all the same and fully deserved its success" (1954, p. 185).

Rothbard's treatment of Smith's work is unfair and inaccurate. His treatment of Cantillon is distorted in the opposite direction. Ironically, many of Rothbard's specific criticisms of Smith would also apply to Cantillon and Turgot.

While it is not difficult now to find "origins" for many of Smith's ideas, his work is far superior to that of the predecessors. Often this superiority lies in making explicit what was only implicit, and in explaining rather than merely asserting. There are two major analytical achievements of *The Wealth of Nations*. The first is the comprehensive depiction of a self-adjusting general-equilibrium system embracing product markets and factor markets and extending to international as well as domestic activities. The second is a representation of benign economic growth. These analytical devices then form the basis for a comprehensive criticism of government economic interventions, supplemented with a powerful analysis of

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"government failure." The analysis is conducted with a consistently humanitarian viewpoint and presented in numerous passages of superb rhetoric which reflect moral passion, humor, sarcasm, and simple explanatory patience and clarity.

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MURRAY ROTHBARD'S ADAM SMITH

SPENCER J. PACK

This article argues that Murray Rothbard does indeed have scathing criticisms of Adam Smith in Rothbard's recent work on the history of economic thought. It points out, though, that Rothbard had quite harsh words for many eminent economists. Moreover, in terms of *methodology*, Rothbard basically felt that he possessed certain key economic truths. People who did not share these truths were, in Rothbard's eyes, quite simply wrong.

Following Rothbard's lead, the article then summarizes key areas in which Smith indeed held views quite different from those of Rothbard. Moreover, the article argues that the situation is possibly even worse than Rothbard himself realized. Drawing upon lesser known parts of Smith's work, including *Essays on Philosophical Subjects, Lectures on Rhetoric and Belles Lettres, Lectures on Jurisprudence*, and *Correspondence*, the article claims that Smith seems to have been an epistemological skeptic, and that he had a proto-Marxist dialectical theory of socioeconomic development. For Smith, the state necessarily arises with the development of private property and inequality in wealth, and it exists to protect the rich from the poor. Hence, the differences between the thought of Rothbard and Smith were possibly even greater than Rothbard himself recognized. Nonetheless, the article concludes that Rothbard was essentially astute, correct, and honest in recognizing and emphasizing the distance between his thought and that of the iconic Adam Smith.

Rothbard's two-volume text on the history of economic thought[1] contains surprisingly strong statements against Adam Smith. For example, according to Rothbard, Smith "originated nothing that was true" (Rothbard 1995a, p. 435); Smith "contributed nothing of value to economic thought" (ibid., p. 463); his doctrine of value was an "unmitigated disaster" (ibid., p. 448); his theory of distribution was "disastrous" (ibid., p. 458); his emphasis on the long run was a "tragic detour" (ibid., p. 451); and Smith's putative "sins" (ibid., p. 452) included introduction into economics of the labor theory of value.

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[1]The books referenced in this article are *Economic Thought before Adam Smith: An Austrian Perspective on the History of Economic Thought*, Vol. 1 and *Classical Economics: An Austrian Perspective on the History of Economic Thought*, Vol. 2. References will appear in the text as (Rothbard 1995a) and (Rothbard 1995b) respectively.

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At first reading, Rothbard's criticisms of Smith seem unduly severe; it is, arguably, one of the harshest attacks ever made upon Smith's work by a non-Marxist (or indeed, any) economist. Yet, consideration of Rothbard's rhetoric and methodology sheds light on Rothbard's style. From Rothbard's point of view, his lambasting of Smith certainly makes sense. Indeed, had Rothbard been more familiar with some of the lesser known parts of Smith's oeuvre, his thrashing of Smith might have been still more severe.

First, in terms of rhetoric, Rothbard has rough stuff to say about most everyone with whom he disagrees. Rothbard was a man of unusually strong views and clear convictions of what is right and wrong, correct and incorrect. He did not mince words. So, for example, the *Tableau Économique* of Quesnay is judged to be "irritating," "elaborate frippery," "false," "mischief-making," "deceptive," and in no sense did it "do anything but detract and divert attention from genuine economic analysis and insight" (Rothbard 1995a, p. 376). Ricardo had "a deductive system built on deep fallacy and incorrect macro-models" (Rothbard 1995b, p. 82). Marx was a "sponger" and a "cadger" with a corrupt attitude toward money (ibid., p. 340) whose economics was a "tissue of fallacies. Every single nodal point of the theory is wrong and fallacious" (ibid., p. 433). The conservative economist Thomas Sowell is chastised for having written "the most spectacularly overrated work on Marxism" (ibid., p. 497); "a remarkably frenetic and unconvincing whirl of Marxian apologetics" (ibid., p. 436, n. 36). On John Stuart Mill: "It is difficult to think of anyone in the history of thought who has been more egregiously and systematically overestimated as an economist, as a political philosopher, as an overall thinker, or [even!] as a man" (ibid., p. 491). At least Rothbard did not attack Adam Smith's reputation as a male.[2]

Second, in considering Rothbard's rough handling of Smith, one needs to take into account Rothbard's methodological strategy in writing his *Economic Thought before Adam Smith*, volume 1. Essentially, Rothbard asks: How does a historical theorist compare with his own views on such crucial topics as the subjective theory of value, laissez-faire, the fractional reserve banking system, and scientific methodology (i.e., praxeology)? When Rothbard disagrees with the theorist, that theorist is basically wrong. In Rothbard's view, there is generally not room for another completely different theory or viewpoint. For Rothbard, "knowledge can be and is lost as well as gained . . . paradigms and basic truths get lost, and economists . . . can get worse" (Rothbard 1995a, p. 438). Rothbard assumes that he knows truth and can recognize scientific progress. He has "a vision of the historical process as a permanent struggle between truth and falsehood, economic wisdom and blundering" (Hoppe, p. 250). Truth can be discovered and distinguished from falsehood; there is one truth; general principles can be known with certainty. For Rothbard, economics does not so much approach truth. Rather, economists tend to get, grasp, or understand truth; and then other economists tend to lose it. This is why, for Rothbard, there can be retrogression as well as progress in the history of economic thought.

When Rothbard comes to Smith's work, he finds that there is indeed a wide gulf between what Rothbard holds to be the truth and Smith's own views. Hence the

[2]This has been done, and rather successfully too. See Justman's (1993) entertaining book.

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ensuing harsh criticisms; and, from Rothbard's perspective, these criticisms are essentially correct.

As Rothbard correctly stresses, Smith does not believe in a subjective theory of value, nor does he follow any kind of utility theory of value. Causality for Smith runs from costs of production to consumer goods prices; it does not run from consumer valuation to consumer goods prices to the pricing of productive factors (i.e., the costs of production). Smith writes about alienated labor, and he tries to distinguish between unproductive and productive labor. Smith advocated usury laws and he "favored low and criticized high profits because high profits induce capitalists to engage in excessive consumption" (Rothbard 1995a, p. 447). Scarcity plays virtually no role in *The Wealth of Nations*. Smith emphasized long-run "natural" price. He did not use the concept of the entrepreneur (or one might say that he severely minimized the role of the entrepreneur). Smith discarded the entrepreneur as an admirable risk-bearer and forecaster; instead, Smith generally deprecated "projectors" whom he felt squandered resources through dubious ventures and excessive risk-taking.

Cost for Smith is somehow determined objectively and largely exogenously from the market. Smith does have a cost-of-production analysis which, in turn, rests insecurely upon some sort of labor theory of value. As Rothbard correctly states, "Marx was, in this matter, simply a Smithian–Ricardian trying to work out the theory of his masters" (Rothbard 1995a, p. 455).[3] For Smith, rent and profit can be viewed as deductions from the produce of labor. This indeed leaves "the door open for later socialists who would call for restructuring institutions so as to enable workers to capture their whole produce" (ibid., p. 456).

Smith indeed thought little of landlords, writing that they "like to reap where they never sowed and demand a rent even for its natural produce" (Rothbard 1995a, p. 456). For Smith, wages in the short run are "determined by the relative 'bargaining power' of employers and workers" (ibid., p. 459). As Rothbard points out, Smith's theory of rent is indeed a befuddled mess.

In terms of economic policy, Smith does introduce numerous "waffles" in laissez-faire policies; his championing of laissez-faire was not consistent. As Rothbard correctly notes, Smith supported the British navigation acts in the name of national defense; he was for government involvement in education; Smith was for the regulation of bank paper, including outlawing small denomination notes; Smith favored some public works; and government coinage; and government control of the post office; and he was for the compulsory building of fire walls; and the compulsory registration of mortgages; and the outlawing of the practice of paying

[3] Marx (p. 104):

> It was an immense step forward for Adam Smith to throw out every limiting specification of wealth-creating activity—not only manufacturing, or commercial or agricultural labor, but one as well as the others, labor in general. With the abstract universality of wealth-creating activity we now have the universality of the object defined as wealth, the product as such or again labor as such, but labor as past, objectified labor. How difficult and great was this transition may be seen from how Adam Smith himself from time to time still falls back into the Physiocratic system.

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employees in kind; and other government involvements in the economy (Pack 1991, pp. 51–72; Viner, pp. 116–55; Rosenberg, pp.19–34).

There were numerous taxes advocated by Smith. He urged higher taxes on uncultivated land, and heavy taxes on luxurious consumption to tax the indolence and vanity of the rich. Smith appeared to be for progressive income taxation. He spent the last twelve years of his life as a commissioner of Scottish customs. He was for the compulsory automatic warehousing of all imports to hurt smugglers. Smith felt that there should be a government, and the government needed taxes to support it.

As far as banking policy is concerned, Smith embraced the institution of fractional reserve banking. He praised the expansion of bank credit and money within a specie-standard framework. From Rothbard's point of view, all of the above views are serious errors, fallacies, and deviations from the truth.

Let us now consider Rothbard's methodology in a bit more detail, since that too is so different from Smith's methodology. For Rothbard, the praxeological method "is the only one that bases theory on broadly known and deeply empirical—indeed universally true—premises! Being universally true, the praxeological method provides *complete* and general laws" (Rothbard 1995b, p. 152). Praxeology "arrives at truths about the world and about human life that are absolute, universal and eternal—at least while the world and humanity last. It arrives, in short, at a system of natural laws." Economic theory penetrates "truths about human action which are absolute, unchanging, and eternal, which are unaffected by changes of time and place. Economic thought, at least correct economic thought, is itself a subset of natural laws." Hence,

> the existence of human action, the eternal pursuit of goals by employing scarce means, the diversity and inequality among men, . . . apply to all of human life, at any time and place. Once articulated and set forth, they impel assent to their truth by a shock of recognition; once articulated, they become evident to the human mind. (Rothbard 1995a, p. 19)

For Rothbard, praxeological theory is "grounded on deductions from fundamental axioms so broadly empirical as to be virtually self-evident" (Rothbard 1995a, p. 19). Hence, "eternal natural truths about economic aspects of politics may be and have been arrived at" (ibid., p. 20).

In contradistinction to Rothbard, Smith himself seems to have been a thoroughgoing skeptic. As the philosopher Charles Griswold points out in a perceptive essay on Smith's *Theory of Moral Sentiments*, "in theorizing about ethics Smith enacts Skeptism. He may therefore be interpreted as following out Hume's skeptical program to its limit, and perhaps as doing so more consistently than Hume did" (Griswold, p. 228). Rothbard, of course, recognizes that David Hume was a skeptic, and states that Hume's *Treatise* "was pivotal in its corrosive and destructive skepticism" (Rothbard 1995a, p. 425). For Rothbard, skepticism is the worst groundwork for individual liberty (ibid.; also p. 201). While Rothbard is aware that Smith and Hume were friends, he seems to be insufficiently cognizant of the depth of Hume's influence upon Smith's methodology.[4]

[4]To acquire a real feel for the intimate closeness of the relationship between Smith and Hume, consult the relevant letters (Smith1977).

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Smith treated Newton's physics as a "mere invention of the imagination."[5] In Smith's view, science does not necessarily disclose truth, nor approximate reality (Pack 1993). Science for Smith seems to be largely successful stories designed to calm humans; hence, the importance of rhetoric for Smith.[6] Scientific theories for Smith are products of and appeal to the imagination. Unlike Rothbard, for Smith humans do not discover theories; rather, humans imagine and create them (Pack 1995, 1996b).

Rothbard is wrong in believing that "Smith retreated from the absolutist, natural-law position that he had set forth in his ethical work *The Theory of Moral Sentiments*" (Rothbard 1995a, p. 465). Again, largely following Hume, Smith basically did not utilize a natural-law or natural-rights framework. His book on *The Theory of Moral Sentiments* was an elaborate argument for why humans can get along in society and why they do indeed have morals, wrapped around his theory of "sympathy." Although a case can be made that Smith's theory of justice was partly grounded in a natural-law position—after all, Smith did write that "the rules of justice are the only rules of morality which are precise and accurate" (Smith 1976, p. 327)— Smith for the most part never used natural-rights and natural-law theory.[7]

Indeed, it is when we get to Smith's position on justice and jurisprudence that the differences between Smith and Rothbard become most striking. Recall that for Rothbard, "the truth, of course is . . . the state, through history, has been the main despoiler and plunderer of private property" (Rothbard 1995b, p. 334). Also, for Rothbard, "all classes live in harmony through the voluntary exchange of goods and services that mutually benefits them all" (ibid., p. 380). Rothbard feels that "modern anthropological research . . . has demonstrated that most primitive and tribal societies were based on private property, money, and market economies" (ibid., p. 312, n. 1).

In contradistinction to Rothbard, Smith's lectures on jurisprudence, particularly in the more extensive lecture notes that were first published in 1978,[8] display an almost Marxist quality. There Smith presents a dialectical interplay between the level of economic development of a society, which he divides into the age of hunters, shepherds, farmers and the commercial age, and a society's legal and political institutions.[9] Smith is barely able to say a thing about a law or legal right without first specifying the level of socioeconomic development of that society. For Smith, rights, laws, and government are all dependent upon the level of the material development of society. As the Marxist Meek (and one of the editors of the Glasgow

[5]See his "The Principles which Lead and Direct Philosophical Enquiries; Illustrated by the History of Astronomy"; also his so-called "History of the Ancient Physics" and "History of the Ancient Logics and Metaphysics" as well. These latter two essays are also prefaced by the same significant title "The Principles Which Lead and Direct Philosophical Enquiries." These three essays are actually all part of one unfinished work written by the young Adam Smith. They are a key source for understanding Smith's methodology (Smith 1980).

[6]See Smith's *Lectures on Rhetoric and Belles Lettres* (1983).

[7]See the chapters on Hume, Smith, and John Millar in Haakonssen (1996).

[8]It is significant that Smith was originally hired at Glasgow as a professor of logic and that he gave these lectures in the logic course. He continued to teach this course as an "elective" even after he transferred to the chair of moral philosophy.

[9]For a study that stresses the dialectical nature of Smith's work in general, see Brown (1988).

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Edition of Smith's *Lectures on Jurisprudence*, p. 16) perceptively points out, "it could very plausibly be argued, indeed, that it is in Smith's numerous remarks about the influence exerted upon the character of individuals, social classes and nations by the manner in which the people concerned get their living, about the relativity of manners and morals to time and place, and about the socio-economic determinants of political attitudes, literary styles, consumption patterns, etc., that the main similarities between his approach and Marx's are to be found."

Smith's *Lectures on Jurisprudence* are organized around a proto-Marxist four-stage theory of socioeconomic development. These lectures hold that the law and government of a society are basically dependent upon the level of economic development of that particular society. As the socioeconomic level of a society changes, its rules, regulations and governmental system will also change. This dialectical interplay between history, the economy, and cultural institutions is perhaps most clearly evinced in Smith's handling of marital relations and women, (Nyland 1933) as well as his analysis of slavery (Pack 1996a). From these jurisprudence lectures, it is clear that for Smith his *Wealth of Nations* is socially specific to what he calls the commercial stage of society (Pack 1991, pp. 119–37).

For Smith the state arises with the rise of private property and shepherd society: "The appropriation of herds and flocks, which introduced an inequality of fortune, was that which first gave rise to regular government. Till there be property there can be no government, the very end of which is to secure wealth, and to defend the rich from the poor" (*Jurisprudence*, p. 404). According to Smith, "Property and civil government very much depend on one another. The preservation of property and the inequality of possession first formed it, and the state of property must always vary with the form of government" (ibid., p. 401). Smith is quite candid that "laws and government may be considered in this and indeed in every case as a combination of the rich to oppress the poor, and preserve to themselves the inequality of the goods which would otherwise be soon destroyed by the attacks of the poor" (ibid., p. 208).

Hence, Smith approves of a certain amount of social stratification as necessary to any sort of post-primitive society. He approves of the role of the state, which exists largely to protect the rich from the poor. The commercial state depends upon taxation, and consequently it is not too surprising that Smith chose to spend the last years of his life working for the Scottish customs. By Smith's thought, commercial society needs the state which in turn needs tax revenues, and Smith endeavored to be a good citizen of the state. Smith was no libertarian.

It has been held that "Rothbard ranks among the great social thinkers. A system-builder, he is the architect of a rigorously consistent social philosophy" (Hoppe, p. 249). People who largely agree with Rothbard's views may want to reread their Smith. There is indeed a wide gulf between the thought of Smith and Rothbard. In my opinion, Rothbard is essentially correct, astute, and honest in recognizing and emphasizing the size of the distance separating his thought from that of the iconic Adam Smith.

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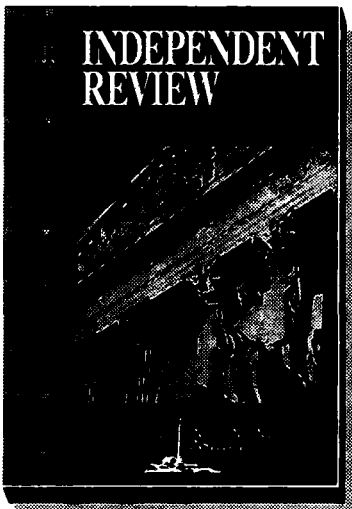

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SOCIALISM AND WAR: ESSAYS, DOCUMENTS, REVIEWS: THE COLLECTED WORKS OF F.A. HAYEK, VOLUME 10. EDITED BY BRUCE CALDWELL. CHICAGO: UNIVERSITY OF CHICAGO PRESS, 1997

This volume of F.A. Hayek's collected works brings together chapters, articles, and reviews Hayek wrote between 1935 and 1949. The volume's editor, Bruce Caldwell, has divided the contents into three parts: market socialism and the socialist calculation debate; the economics and politics of war; and planning, freedom, and the politics of socialism. Readers familiar with Hayek's 1944 book, *The Road to Serfdom*, will find that its themes and arguments relate closely to the ideas expressed in the papers collected here.

Part I contains Hayek's introductory and summary chapters of the important 1935 volume he edited, *Collectivist Economic Planning: Critical Studies on the Possibilities of Socialism*, two journal articles, a book review, and the foreword he wrote for Boris Brutzkus, *Economic Planning in Soviet Russia* (1935).

In these papers Hayek traced the history and nature of the socialist calculation problem. He observed that the issue had been brought to the forefront by

> the experience of the war years, when the states had set up food and raw material administrations to deal with the serious shortage of the most essential commodities. It was generally assumed that this had shown that not only was central direction of economic activity practicable and even superior to a system of competition, but also that the special technique of planning developed to cope with the problems of war economics might be equally applied to the permanent administration of a socialist economy. (p. 71)

Although Hayek credited the German sociologist Max Weber and the Russian economist Boris Brutzkus with having "arrived independently at very similar conclusions" (p. 74), he gave pride of place to his mentor Ludwig von Mises for having shown the necessity of a money price system for rational allocation of resources and, most importantly, for having presented a "detailed demonstration that an economic use of the available resources was only possible if this pricing was applied not only to the final product but also to all the intermediate products and factors of production" (p. 74). Hayek also clarified Mises's enigmatic statement that socialism was impossible: "what he meant was that socialism made rational calculation impossible" (p. 76).

Hayek described how socialist planning would fail as follows:

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> There is no reason to expect that production would stop, or that the authorities would find difficulty in using all the available resources somehow, or even that output would be permanently lower than it had been before planning started. What we should anticipate is that output, where the use of the available resources was determined by some central authority, would be lower than if the price mechanism of a market operated freely under otherwise similar circumstances. (p. 91)

In response to socialists who proposed that central planning required only that the planners solve the appropriate set of Walrasian equations, Hayek described the proposal as "humanly impracticable and impossible" (p. 93) and characterized its proponents as having failed to perceive the real nature of the problem. Socialist economists erroneously assumed various forms of knowledge to be "given" when in reality such knowledge is only discovered by people engaged in the competitive process. Moreover, much knowledge is dispersed and specific to time and place, and much knowledge is not transmissible but tacit, pertaining not so much to "what is" as to "how to." Socialist economists displayed an "excessive preoccupation with the conditions of a hypothetical state of stationary equilibrium" (p. 105), but actual economies are dynamic, undergoing constant change. Aiming to abolish profits, the socialists overlooked the essential role of profits as an equilibrating force. "To assume that it is possible to create conditions of full competition without making those who are responsible for the decisions pay for their mistakes seems to be pure illusion" (p. 112).

In a 1940 *Economica* article, Hayek took on the so-called market socialists, Oskar Lange and H.D. Dickinson. He concluded that these theorists had failed to solve the problems identified by their critics. Even if the planners were competent and completely devoted to serving the public interest—outrageous assumptions but ones Hayek was willing to make for purposes of discussion—they had no way to employ inherently dispersed knowledge or to adjust quickly to the constant changes of the real world. In addition, without a capital market, "the decision of how much to save and invest would necessarily have to be arbitrary" (p. 133).

Part 2, which deals with war-related issues, contains articles and reviews written for such outlets as *The Banker* and *The Spectator* as well as Hayek's review in the *Economic Journal* of John Maynard Keynes's notable pamphlet *How to Pay for the War* (1940).

Responding to calls for the establishment of resource priorities and rationing by government, Hayek observed that in wartime no less than in peacetime, costs cannot be ignored and rational resource allocation requires a price system: "It is a common fallacy to assume that in the conduct of war everything is needed so urgently that cost does not matter" (p. 152). He also exploded the fallacy that speedier production has no cost: "even in wartime it is rarely justifiable to think only of the effects in the shortest of periods without regard to the consequences" (p. 153).

Hayek endorsed Keynes's 1939 scheme to use forced savings to help finance the war, calling the proposal the product of "the most fertile mind among living economists" (p. 164). Hayek preferred, however, that rather than repaying the wartime takings in cash installments after the war, timed along Keynesian lines to offset the expected postwar slump, the government would impose "a capital levy

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on old wealth," giving the lower-income taxpayers what would amount to shares in the private capital stock. When Keynes refined his scheme in 1940, he adopted the idea of a capital levy, crediting Hayek for suggesting it. In his review, however, Hayek objected that "the purpose for which I proposed [the capital levy] was very different from that to which Mr. Keynes intends to put it" (p. 171)—namely, to finance the postwar discretionary cash repayments Keynes had proposed initially.

Part 3 contains a 1938 magazine article and a 1939 pamphlet that clearly prefigure *The Road to Serfdom*, two articles on how and why scientists and intellectuals tended to support socialism, and half a dozen reviews of books on central planning and related topics.

As early as 1941, in a book review published in *The Spectator*, Hayek had encapsulated his characteristic themes in the form of a rhetorical question:

> Is it not possible that all that planning and direction, which in Germany longer than elsewhere has been universally demanded, necessarily require a "totalitarian" regime, arbitrary preferences, the use of force, and the institution of a new hierarchical order of society, and that only the most ruthless and unscrupulous are capable of satisfying the clamour of the masses for "action," while the decent falter and fail when faced with the concrete task? (pp. 174–75)

As we know, most opinion leaders rejected Hayek's argument that planning would necessarily lead to totalitarianism, arguing that democracy would protect the public from government excesses. Hayek disagreed. As he wrote in 1939, "only capitalism makes democracy possible. And if a democratic people comes under the sway of an anti-capitalistic creed, this means that democracy will inevitably destroy itself" (p. 185).

A highlight of Part 3 is Hayek's 1949 article "The Intellectuals and Socialism," originally published in the *University of Chicago Law Review*. Hayek argued that the intellectuals, "second-hand dealers in ideas" whom he distinguished from "the real scholars or experts," exercise great influence. "Even though their knowledge may be often superficial and their intelligence limited, this does not alter the fact that it is their judgment which mainly determines the views on which society will act in the not too distant future" (p. 225)—another instance of agreement between Hayek and Keynes, whose own statement in this regard has become a cliché. Hayek maintained that "neither selfish interests nor evil intentions but mostly honest convictions and good intentions . . . determine the intellectuals' views" (p. 227). Hence Hayek's lifelong, always courteous attempt to set the collectivist intellectuals straight. Even after fifty years, Hayek's speculations about why the intellectuals tend toward collectivism make provocative reading.

Caldwell has performed admirably as editor of this volume. His 50-page introduction provides much background and context for the collected papers and helps to clarify Hayek's arguments. His explanatory notes scattered throughout the text are also informative.

Caldwell advances interesting speculations about why forty years elapsed before these papers began to bear significant intellectual fruit in the economics profession. Of course, Hayek's views were completely out of step with the ideological

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(collectivist) and scientific (positivist) persuasions of most economists from 1935 to 1975. But economists did not exactly refute Hayek's ideas. As Caldwell aptly observes, "few economists ever really seemed to have understood what Hayek was saying" (p. 29). Why not?

> Whether one is a neoclassical or a market socialist, one's principal goal as an economist is the same: to make one's chosen system more efficient, using the marginal conditions provided by the Paretian system as the benchmark. . . . Hayek's ultimate endorsement of markets is not based on their alleged Pareto-efficiency characteristics. Rather, a system of free markets is one among a number of institutions that are vital for the creation and discovery of knowledge and for the coordination of agents' plans in a world in which knowledge is dispersed and error is possible. By assuming away these essential characteristics of the market process, the Paretian paradigm completely obscures the Austrian message. (pp. 29–30)

Also, Hayek argued in words, but mainstream postwar economists increasingly resisted accepting any kind of argument unless it had been formalized in the prescribed mathematical fashion.

This volume makes an important contribution to Hayek's *Collected Works*. Many of the papers in it will be read for years to come. Scholars are fortunate to have them available in such a convenient and skillfully edited form.

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LIBERTARIANS AND LIBERALISM: ESSAYS IN HONOUR OF GERARD RADNITZKY, EDITED BY HARDY BOUILLON. AVEBURY: ALDERSHOT, 1996

This *Festschrift* is dedicated to one of the outstanding champions of liberty in Germany. For most of his scientific life, Gerard Radnitzky has been known as a philosopher of science in the tradition of Karl Popper. In recent years, however, he has won a reputation as a staunch defender of individual liberty through many publications in books and scholarly journals like *Aufklärung und Kritik*. Most notably, with his disciple Hardy Bouillon, he edited the three-volume *Values and the Social Order*, which contributed significantly to the spreading of Austrian ideas about society, economy, and government.

This emphasis is reflected both in the title of the *Festschrift* and in the contributing authors. The book is organized in three sections. Section 1 features articles dealing with the links and lapses of libertarians and liberalism. Section 2 centers around a critical analysis of social choice-democracy, and section 3 examines the future of freedom. Most of the authors are either American scholars like Walter Block, Hans-Hermann Hoppe, and Hans F. Sennholz, or German scholars like Gerd Habermann, Hardy Bouillon, Roland Baader, Herbert Giersch, Manfred Streit, and Detmar Doering. Among the other contributors are Prime Minister Václav Klaus from the Czech Republic, Arthur Seldon, and Angelo M. Petroni. Although most of the articles merit careful study, my remarks will focus on the articles by Habermann, Bouillon, and Doering, which appear to be particularly interesting from a theoretical point of view.

In *Libertarians and Liberalism*, Gerd Habermann critically examines the premises and tenets of Rothbardian anarcho-captalism. In his conclusion he defends classical liberalism, although recognizing many merits of libertarian political philosophy. States Habermann: "Every liberal will gain much from an intensive study of this current of thought, but its limits should be equally clear to him, limits also known by all forms of constructivism" (pp. 72f). Habermann's main argument for the rejection of anarcho-capitalism is that it is a "generalization of the free-market model and economic motivation" (p. 72). Therefore,

> anarchist capitalism fails to find application in areas of society where market forces are not at work. . . . Its theory hinders appreciation of the value of communities founded on real fellowship and of their claims in a world in which groups compete with one another. (p. 73)

This statement will certainly surprise readers acquainted with the work of Murray N. Rothbard. Rothbard conceived of anarcho-capitalism as the economic

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aspect of a society built on natural law. He argued that markets cannot work without a natural-law legal framework. Therefore, economic science is a corollary, and not the basis, of political philosophy. Habermann seems to confuse Rothbard's views with the arguments of David Friedman. He contends: "Contemporary libertarian anarchism, as forwarded by Rothbard, David Friedman, and others, is characterized by its bolstering of traditional individualist–anarchist positions with a modern economic foundation" (p. 51). Similarly, Habermann notes that the "same subject comes up for discussion with insistent monotony: the individual and his property. Discussion is limited to economic questions" (p. 65). Habermann seems to imply that private property is merely the basis for *market* transactions.

Nothing could be further from the truth, though, as even the most insensitive reader will grasp from a short glance at Rothbard's *Ethics of Liberty*. For it is precisely in this important work that Rothbard demonstrates that private property is the basis of *all* kinds of non-aggressive human interaction—and not only of market behavior. Rothbardians need not assume, as Habermann stipulates, an "anarchist ideal of the lonely gunfighter 'going it alone'" (p. 72), or the "fiction of an autonomous individual who creates his individuality *ex nihilo*" (p. 71). Rather, from the point of view of Rothbard's argumentation, it is entirely irrelevant whether people act alone or in concert. A free society is not characterized by isolated individuals but by individuals who, in all manner of social bonds, respect the property of their fellows.[1] Of all this, Habermann has grasped nothing. Instead he builds up and bashes his own straw men. *Voilà,* one of the pictures that Habermann attacks:

> Everything that the individual does not freely choose and agree to is regarded [by the libertarians] as an arbitrary, oppressive burden. Individuals have no attachment to society, are literally free and independent, themselves the only ones to create and shape their own lives without criteria, unaided by collective norms and standards. (p. 71)

No doubt, such a theory hinders appreciation of the value of communities founded on real fellowship. But what has this to do with Rothbard's political philosophy? The reader of Habermann's article is struck with astonishment. How can one explain such a serious misunderstanding? I am tempted to believe that Habermann is not acquainted with *The Ethics of Liberty*, as one finds in his references no mention of this book. Of course, this is a grave omission considering the purpose of Habermann's article and the conclusions he derives from it. The omission can be excused only by the fact that the book is for a long time out of print and—especially in Germany—practically not available.[2]

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[1]This point has been stated lucidly by Walter Block in his article "Libertarian Perspective on Political Economy," in the book under review.

[2]The author of this review can attest to the difficulties of accessing Rothbard's work through German public libraries. In the biggest libraries of Berlin, for example, only Rothbard's economics books are available. Fortunately, *The Ethics of Liberty* will be reprinted again in 1998, by New York University Press, in cooperation with the Mises Institute and the Center for Libertarian Studies. There is also a French translation, published by *Les belles lettres, édition laissez-faire.*

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It would be vain to speculate further about the question of whether Habermann misunderstands Rothbard's libertarianism to such an extent. The fact is that he *does* misunderstand it, and consistently so. Thus, according to Habermann, an "important premise" of libertarianism is that in a free society "non-domination and non-aggression are the rule" (p. 52). If this were the case, then libertarianism would indeed be a philosophy for nirvana and meaningless for human life. But this alleged premise is, of course, immaterial for libertarianism. Rather, libertarians assert that, no matter how much violence exists in any given society, violent producers of security (governments) merely increase this level. Therefore, they should be abolished in favor of non-violent producers of security.

But what would be different and what would be gained, Habermann asks, if the private security agencies turned into violent ones and made their clients into "private subjects" (p. 68)? Habermann does not see that, even if nothing was different and nothing was gained in such a case (which is not true), this possibility could not be an argument in favor of government. For this would imply the somewhat weird logic that the mere possibility that someone might exercise violence *in the future* justifies another person or group to exercise violence *right now*.

It is regrettable that Habermann does not abstain from using the most ridiculous of all charges against the libertarians: their "constructivism." According to Habermann, this kind of thinking "assumes that all relevant facts can be known to an individual and that it should be possible for the individual to derive from the knowledge thus gained a definitely 'right' and eternally valid social order" (p. 64). Yet, what is wrong with constructivism in this sense? Does Habermann not share these very assumptions when he claims that libertarianism is the wrong, and democratic government the right, social order? He would probably retort that it does not "detract from the value of a purely normative principle to admit that it is inherently subjective" (ibid). In other words, there is no such thing as justice and natural law: "The claim that an individualistic natural law, as interpreted in Western countries, is universally applicable is simple presumption" (ibid). Well roared, lion! Yet, before one makes such a general statement one should try to refute the existing counter-arguments. This holds true especially in the present case, since there exists a private-property ethic that claims universal validity, that is, Hoppe's libertarian argumentation ethic. But again, Habermann shows astounding *lacunae*. He makes no attempt to refute Hoppe's tenets, nor does he even mention Hoppe's *Theory of Socialism and Capitalism* in his article. Thus, Habermann's denial of natural law is mere assertion. Here as in all the other topics he raises, he fails to make one valid point against the libertarian social philosophy of the Rothbardian brand.

Hardy Bouillon recently published a book entitled *Freiheit, Liberalismus und Wohlfahrtsstaat* (Baden-Baden: Nomos, 1996) in which he developed a new definition of liberty. His article in the *festschrift* "Defining Libertarian Liberty" is a short, English-language exposition of the main thesis of his book. Starting from a critique of the Hayekian definition of liberty, he distinguishes between two levels of decision: "object-decisions" and "meta-decisions." On the basis of this distinction, he arrives at the following definition of liberty: "Freedom is the absence of artificial

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interference in the private sphere of another that would mean artificial costs to him if he opted for a negative meta-decision" (p. 102).[3]

Hayek's concept of liberty has in the past been the subject of several thorough refutations.[4] Therefore, I shall concentrate my discussion on Bouillon's own proposal. The most original aspect of his definition is the distinction of decision levels. What are, then, object-decisions and meta-decisions? According to Bouillon, an object-decision "is characterised by the fact that it constitutes a decision among different objects. . . . The number of objects does not influence the character of an object-decision" (p. 101). As an example, he gives the choice between apples, oranges, or bananas when buying at a merchant's shop. By contrast, a meta-decision "is a decision between staying to [one's] original plan or deviating from it, hence an 'either-or-choice'. Having these two, and only these two, alternatives is a constitutional character of a meta-decision" (ibid). Having established these definitions, Bouillon proceeds to illustrate their usefulness for the distinction between liberty and coercion:

> Suppose, you liked to keep your money and your life. Suppose also, an armed robber asked for your "Money or your life!" That would be a clear case of what we used to call coercion.
>
> Suppose now, that, *ceteris paribus*, the same person would be unarmed and obviously unable to threaten or extort from you in any possible way, and suppose, that very person would kindly ask you to give him either your money or your life. Then we would not say that he coerces you.

Now, let us separate the meta-decision from the object-decision. With regard to the object-decision, the two cases (A and B) do not differ. In both cases you have the choice either to give your money or your life. Hence, in both cases the costs of your object-decision will be the same.

With regard to the possible meta-decisions, we notice a difference. The costs of a positive meta-decision (i.e., to consider the offer of the person), however huge, are the same in both cases. Nonetheless, the costs of a negative meta-decision (i.e., to ignore the offer of the person) differ decisively. In the first case you have to expect additional costs imposed by the person (e.g., being shot or hurt). In the second case you do *not* have to expect such costs. Hence, under the above mentioned preconditions, the difference between a case of coercion and a case of free choice is in the artificial costs that are to be expected in a case of a negative meta-decision (pp. 101f).

From this discussion he derives the definition of liberty that we have quoted above. Now, let us first of all examine the validity of Bouillon's distinction between object-decisions and meta-decisions. I venture to deny this validity for three related

---

[3]Bouillon defines "artificial interference" as "intentional interference in the private property of another person, sufficient to produce the intended effect" (p. 102). "Artificial costs" are costs that "*must be intended and sufficiently caused by that person in question*" (p. 103, n. 13).

[4]See, for example, Murray N. Rothbard, "F.A. Hayek and the Concept of Coercion," in idem, *The Ethics of Liberty* (Atlantic Highlands, N.J.: University Press of America, 1982), pp. 219ff; Hans-Hermann Hoppe, "F.A.Hayek on Government and Social Evolution: A Critique," *Review of Austrian Economics* 7, no. 1 (1994): 67–93.

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reasons. First, a meta-decision does not merely concern the choice between staying to the original plan and deviating from it. For each deviation from a plan implies, *ipso facto*, adherence to another plan. Therefore, a meta-decision is a choice between two plans. Second, there is no such thing as a meta-decision that does not, *ipso facto*, imply a decision about objects. For example, if I cling to my plan not to buy apples from the merchant, then this implies that I keep my money and do not have his apples. Third, there is no such thing as an object-decision that does not, *ipso facto*, imply a meta-decision. For either the choice of the object *is* part of my original plan *or* it is not. There is no third possibility. Hence, Bouillon errs when he states that the two decision levels "might" coincide chronologically (p. 101). In fact, they always do. *Each* meta-decision is also an object-decision.

It follows that those differences between the above cases A and B, that Bouillon identifies on the meta-level, must be accompanied by corresponding differences on the object-level. This is indeed so. The object-decisions in the cases A and B *do* differ. For the choice in case B is not, as Bouillon suggests, to give one's life or to give one's money. There is also a third option, that is, to keep one's life and one's money. It is therefore impossible to distinguish between free and coerced choice on the basis of meta-decisions alone. The distinction between meta-decisions and object-decisions is *useless* for the definition of liberty. Bouillon's definition loses its ground.

However, let us grant Bouillon's distinction between object-decisions and meta-decisions for the sake of argument. Then, still, the definition of freedom he derives from it would not be valid. The reason is his futile attempt to take cost as a criterion for this definition, for cost is always subjective. It is the value of the next most important alternative foregone by the choice of the most important one. Thus, if the absence of "artificial cost" is the criterion for freedom, then we must invariably identify all kinds of peaceful action as coercion. Let us illustrate this with the following example:

> Suppose, you liked to reserve your kisses for your wife and to be married to her. Suppose also, a wealthy lady urged you "kiss me or marry me—otherwise you won't get my money."
>
> Suppose now, that, *ceteris paribus*, the same person would be poor and obviously unable to help or subsidize you in any possible way, and suppose, that very person would kindly ask you to either kiss or marry her.

Obviously, the costs of a "negative meta-decision" differ decisively. In the first case, you have to expect more costs than in the second case. Do we therefore have to infer that either case is a case of coercion? This would lead to a strange conception of liberty. However, this is not all there is to it. Bouillon focuses entirely on the point of view of the criminal's *victim*. What about the criminal himself? Where will Bouillon's cost analysis lead if we take the criminal's point of view? Let us use another illustration:

> Suppose, you liked to rob other people. Suppose also, an armed victim told you "stay away or run away–otherwise I shoot you!"
>
> Suppose now, that, *ceteris paribus*, the same person would be weak and obviously unable to defend himself or hinder you in any possible way, and suppose, that very person would kindly ask you to either stay away or run away.

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Clearly, the costs of a "negative meta-decision" differ decisively. In the first case, you have to expect more costs than in the second case. Do we therefore have to infer that you—the would-be victim—are coerced in either case? Again, Bouillon's analysis would fail by all common-sense standards.

Bouillon might object that in my first example the rich lady in no case violated my property (a term that Bouillon accepts, see p. 99) and that, in the second example, the criminal violates property in both cases. This objection would lead us to the insight that *property*, not the cost of negative meta-decisions, is the correct criterion to distinguish liberty from coercion. What are Bouillon's objections to the to the Rothbardian definition of coercion as invasion of justly acquired private property rights without permission of the owner? He thinks that this definition would imply circular reasoning in certain cases. Suppose that I voluntarily give other people permission to invade my property. Their invasion would then not be counted as aggression. But the term "voluntarily" suggests the very freedom that Bouillon ventures to define (p. 100). Therefore, he rejects this definition. However, it seems that Bouillon has fallen prey to a semantic confusion between "freedom to choose" and "liberty in society." In fact, a definition of liberty, that is, of a free society, does not consist in a definition of freedom to choose. (On the one hand, in *all* forms of human interaction one is in a way free to choose and, on the other hand, *anyone* might claim that he "involuntarily" accepts the use that other persons make of their bodies.) Rather a definition of a free society must delimit the *proper* exercise of one's choice in society. And in order to define which actions are proper in society one does not have to refer to terms like "voluntary," "free will," and not even to the term liberty, but to property. Thus there is no circle at all involved. All actions performed with one's own property are just and constitutive of a free society, and all actions performed with the property of other persons, who do not consent, is unjust and coercive.

In "A Dog's Choice: Which Constitution is the Best?" Detmar Doering sets himself the truly Herculean task of a comparison of various constitutional choices in 16 pages. Yet his synthesis is clearly worked out, and any reader will enjoy his wit and excellent style.

It is obvious that Doering feels uncomfortable with any kind of institutional setting. He sees the institution of a state as being "always the second-best of all solutions," (p. 341) but he is also highly skeptical about the fortunes of anarchism. There are but two maxims that Doering ventures to advocate, although he does not pretend to derive them from principle: pluralism of government-types and decentralization. He does not believe it possible to reestablish a mixed government (ibid). The following discussion will critically examine the outlines of the argument he gives us.

In his discussion of anarchy he sees, by and large, the same problems as Habermann. Doering fears that private producers of security are, or could become, corrupt and establish a coercive power structure. No wise person denies that this possibility is ever present in human life. Only daydreamers look for guarantees. They think that other human beings can give them "security" if only they consent to bondage in exchange. Doering cites Professor Radnitzky as saying "there is no such

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guarantee in any system" (p. 343). The real issue is whether one can *reduce* any degree of human corruptibility and fallibility by imposing a state. An advocate of any form of government would have to deliver such a proof. Doering, however, makes not even the slightest attempt to give us this kind of argument.

A very large part of Doering's article deals with Hans-Hermann Hoppe's comparative analysis of democratic and monarchical régimes. Hoppe has argued that since monarchs are private owners of their countries, they have a longer planning horizon, and thus a lower time preference than do democratic governments. Consequently, they will tend to exploit their countries less than do democrats.[5] Doering sees "a fundamental flaw in this argument. . . . It would mean the loss of the individual's right to self-ownership and property for everybody except the monarch. No libertarian could possibly accept this" (p. 337). Does Doering imply that the lower time preference in monarchies is bought at the expense of higher exploitation? For the loss of the right to self-ownership is not limited to monarchies at all. There are many examples of past democracies that brought about the loss of this right; and without much exaggeration one could claim that modern democracies are not far from this, either. In other terms, Doering seems to overlook that Hoppe's argument—as any economic theorem—is valid only *ceteris paribus*. Assuming the same character structure of the rulers, the theorem goes, monarchs will exploit less than will democrats.

The same flaw underlies Doering's statement that monarchism "always found mercantilism to be the economic system appropriate for its purposes" (p. 338). Even if one neglects the question of whether Doering's observation is correct, one has to point out that Doering apparently does not grasp what a refutation of Hoppe's thesis would require. One would have to show that monarchism logically implies a higher propensity for the establishment of a mercantilist system. Doering does not even attempt to deliver such a proof. He quotes Gordon Tullock in his support, who claims that the "'granting of monopolies' is as much a feature of monarchy as is the appearance of 'friends of the ruler' whose 'enterprise' is to 'court' the ruler in hopes of getting . . . special privileges"; and Doering refers to David Hume "who observed . . . that even an absolute ruler has to act in a way to keep his 'mamelukes and praetorian bands' satisfied" (p. 338). These references are proofs of Doering's scholarly erudition, but not of his tenet. In both quotes one could replace the word "monarchy" with the word "democracy," and the word "ruler" with the words "federal government"—without changing the validity of the statements.

Let us emphasize again that Doering is no admirer of democracies. However, his reluctance to accept Hoppe's analysis—or to refute it by theoretical means—leads him to some otherwise inexplicable contentions. He believes that democracy "as a means of self-defence . . . is still the best thing we have," neglecting that democracy favors irresponsibility and thus breaks the neck of civil virtues. He further believes that this erroneous view has been "confirmed by history. It was a

[5]See Hans-Hermann Hoppe, "The Political Economy of Monarchy and Democracy, and the Idea of a Natural Order," *Journal of Libertarian Studies* 11, no. 2 (1995): 94ff.

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democratic force that made American Independence after 1776; it was democratic force that brought down the Soviet Empire" (pp. 340f).

Although this review has been very selective, and mostly critical, the overall judgment is a positive one. *Libertarians and Liberalism* is a valuable contribution to the discussion of several important problems of political philosophy. It honors a man who has done much for libertarian thought. May he long continue to do so.

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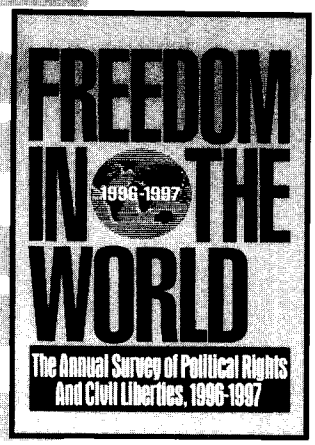

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